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World Economic and Social Survey, 1998*

Part one
State of the world economy

Chapter III

The international economy

The international economy went through a turbulent year in 1997 and, if the first quarter of 1998 is a guide, this will continue for a while longer. The main channels of the turbulence were in the international financial system, but international trade was not immune, especially as regards the volumes and prices of developing-country exports. It is worth keeping in mind, however, that this turbulence sits atop a deep and strong flow of world trade and finance.

The global volumes of trade and financial flows, in other words, grew substantially in 1997. As usual, however, the benefits were spread unevenly. It was a good year to be an exporter of a range of manufactures and services and to retain access to international financial markets. It was not a good year to be a low-income, undiversified exporter of any of several commodities and to rely primarily on official development assistance (ODA) as a main form of financial inflows. It was also not a good year to have a weak domestic financial system that was overexposed to foreign creditors.

The global trade and financial outlook for 1998 is on the whole less dynamic, but still buoyant. This will be a year, however, in which trade adjustments reduce incomes and jobs in several countries, instead of raising them. It will also be another disappointing year for many commodity-dependent countries. Finance will still be plentiful for borrowers with access to markets, if at somewhat higher risk premiums for "emerging market" borrowers, while no generalized break in the disappointing trend is foreseen in ODA flows.

* The present version of the World Economic and Social Survey, 1998 contains eight sections, which are being issued individually. The complete text of the Survey will be issued at a later date as a United Nations publication.

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Moreover, policy changes are under way in 1998 that will change the shape of international economic relations in the twenty-first century and most likely strengthen them. One such development is the decision in the European Union (EU) to establish its planned monetary union at the start of 1999, fully replacing at least 11 national currencies with the new euro by 2002. Another development, which can be directly attributed to the shock of the Asian currency crisis, is a newly intense process of reflection about the shortcomings in the present policy "architecture" of international finance. The review of current international economic developments in the present chapter thus concludes with a special focus on each of these two key policy developments.

Strength and weakness in international trade

The value of world merchandise trade reached about $5.5 trillion in 1997. In 1990, it had been less than $3.5 trillion. At that time, developed countries accounted for over 70 per cent of the total; by 1997 their share had dropped below 64 per cent. The share lost was shifted largely to the developing countries, which supplied and absorbed roughly 30 per cent of total trade in 1997 (see table A.15).[1]

The dynamics of world trade in 1997 and 1998

The volume of world trade grew an estimated 9 per cent in 1997, a considerable pick-up from the relatively slow growth in 1996, which had itself been an adjustment to the very strong pace of growth of the preceding two years (see table A.18). For 1998, despite the economic difficulties in Asia – both in Japan and in several developing countries of the region, as discussed in chapter II – world trade volume is forecast to grow about 7 per cent, which by historical standards will still be a relatively rapid rate of increase.

The growth of world trade depends first on the growth of global demand for traded goods and then on the capacity of exporters to provide the supplies. The strong growth of trade in 1997 can be attributed to a surging growth of imports in all major country groups, albeit with mixed capacities and opportunities of exporters to respond.

Given the high weight of the developed countries in total trade, the almost 9 per cent growth of imports of these countries was particularly significant. In the United States of America, the volume of imports grew by over 12 per cent, under the combined stimuli of strongly rising real income and output and an appreciating real effective exchange rate that reduced the relative price of imports (see tables A.2 and A.10). Canada's import growth was even stronger: 19 per cent. Import growth in Western Europe also strengthened in 1997, if not to the same degree as in North America, as economic growth began to gain momentum in a number of countries. The uncharacteristically slow growth of imports in Japan in 1997 – 2.7 per cent – reflected mainly the pause in its economic recovery and return to weak economic conditions.

Developing countries and economies in transition also saw strong increases in import volumes in 1997. The most dramatic increase – indeed, an unsustainable one – was the 23 per cent growth of import volume in Latin America and the Caribbean, reflecting both the strong growth of gross domestic product (GDP), as discussed in chapter II, and large capital

[1] The transition economies accounted for less than 5 per cent of the world total in 1997 and a somewhat smaller share earlier, although data from before 1994 are extremely difficult to interpret owing to the artificial methods of valuing trade among the member countries of the Council for Mutual Economic Assistance (on this and other issues in measuring trade flows, see the introduction to the statistical annex of this Survey).

inflows that financed sharply wider trade deficits. The growth of China's import volume moderated, but imports still grew by over 9 per cent, supporting the strong growth of its domestic economy. The 8 per cent growth rate registered by South and East Asia reflected the strong performance of some of these economies for the full year and others for the first half of the year.

The volume of imports grew by 6 per cent or more in the other main developing-country regions. In Africa, this represented more than a 50 per cent increase over the rate of growth of imports in 1996, reflecting in part the need for a sharp increase in commercial food imports in several countries where local food production had been hit by bad weather conditions. In the case of Western Asia, import growth slowed sharply from almost a 12 per cent increase in 1996, as the fall in international petroleum prices curtailed import capacity and demand.

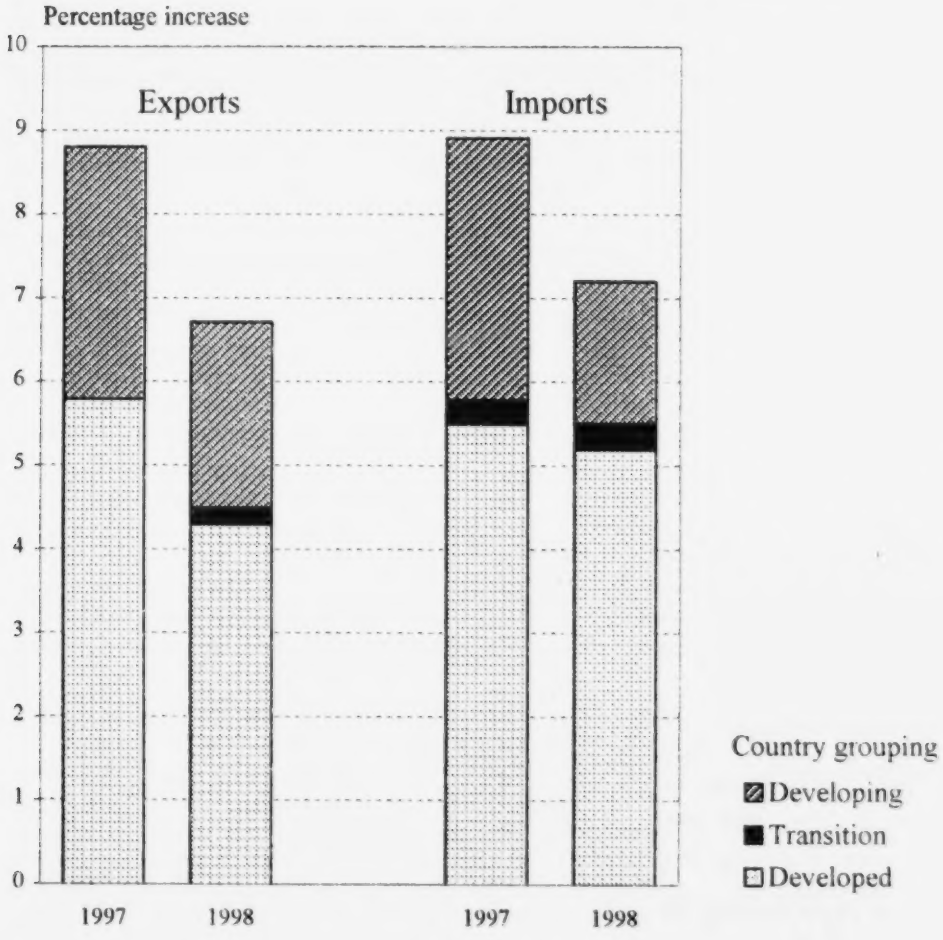
On the export side, the developed countries benefited the most from the increase in world trade, including Japan, whose volume of merchandise exports rose 10 per cent. Western European exports rose almost 8 per cent in volume, largely in sales to other European countries, and North American exports strengthened, especially to Latin America and the Caribbean. China's export volume grew an estimated 26 per cent in 1997, a strong comeback from the pause in 1996, and the exports of South and East Asia grew by over 9 per cent. The volume of West Asian exports declined in the face of weakening global oil demand and strong increases in production by producers in other regions (see below).

For 1998, slower growth is forecast for the volume of world trade, reflecting an expected slower growth of imports on the part of both developed and developing countries. In the case of the developed countries, the very rapid pace of import growth in North America is expected to slow, though still to average over 10 per cent for the year. The volume of imports into Western Europe and Japan is forecast to increase slightly, but not by enough to offset the North American slowdown. The net result is a forecast rate of increase in imports by the developed countries that will be 1 percentage point less than in 1997.

If developing and transition economies were able to maintain their rate of expansion of imports, the rate of increase in world trade would be slowing by about two thirds of a percentage point in 1998 as a result of the developed-country import slowdown. Instead, the growth rate of world import demand is forecast to slow down by about 2 percentage points, as a sharp fall is taking place in the rate of increase of imports by the developing countries (see figure III.1). Imports into the developing countries are forecast to grow by less than 6 per cent, a decline of more than 4 percentage points compared with 1997. This reflects the expected halving of the import growth rate of Latin America and the Caribbean and the near disappearance of import growth in East and South Asia, owing in particular to the crisis in the Republic of Korea and several other Asian economies.

Corresponding to the drop in world import growth is a drop in world exports. However, the slowdown in export growth is more evenly shared: the growth rates of world, developed and developing country exports are each forecast to decline by about 2.5 percentage points (see table A.18). The strongest export volume growth is foreseen in Latin America and the Caribbean, where intraregional trade growth has been strong (see below). The volume of exports from China is forecast to grow almost 9 per cent in 1998, which is of particular relevance to the important policy question of whether the Chinese authorities feel pressured to devalue the yuan renminbi in response to the very large decline in the exchange rates of the Asian crisis countries (see box III.1).

Figure III.1
Contributions to the growth of world trade volumes, 1997 and 1998



Source: UN/DESA.

Box III.1.
Trade and the devaluation question in China

Some authors have pointed to the devaluation of the Chinese Yuan renminbi (Y) in 1994 as one of the precipitating events of the currency crisis in South-East Asia and have wondered whether China will again devalue in response to the sharp fall in the exchange rates of several currencies in that region.[a] The Government of China has announced that it intends to maintain its exchange rate, at least for the duration of 1998, but observers have wondered whether economic pressures arising from the new currency alignments might make it difficult for China to abide by its pledge. While many factors combine to determine whether and when a currency with a fixed exchange-rate peg is devalued, the effect of the exchange rates on a country's "international competitiveness" is commonly deemed to be one of them. However, the reality is more complicated than it at first appears.

Actual developments in relative exchange rates

On 1 January 1994, the official Yuan renminbi exchange rate was changed from 5.8 yuan per United States dollar to 8.3 yuan per dollar, a devaluation of 30 per cent. However, the "actual" change in the exchange rate at that time was less than this, while other changes in the exchange rate had, in effect, occurred earlier.

As part of its programme of economic reform, China adopted a two-track exchange-rate system in 1987: a pegged official exchange rate, and a market exchange rate which was determined in the controlled market in foreign exchange transactions among Chinese companies and enterprises at the so-called swap centres. The Government required that part of the foreign exchange earnings of exporting companies be rendered to the Government at the official exchange rate and the rest, the "retention quota" was left to the firms to trade in the swap centres at the market rate. The market rate of the yuan fell over time and reached 8-10 yuan per dollar in 1992-1993, which was about 30 per cent lower than the official rate of the yuan. Meanwhile, the Government had increased the retention quota of export revenues to about 80 per cent by 1993.[b] At the end of 1993, the Government decided to abolish the two-track exchange-rate system and merged the two exchange rates into one, which at the time, was the market rate in the swap centres.

Thus, the nominal devaluation of the official exchange rate at the start of 1994 overstated the actual devaluation at that moment, which would be better measured as the change in a weighted average of the official and swap rates before and after the rates were unified, with the proportion of trade under the two different exchange rates as weights. Under that calculation, the effective devaluation of the yuan at the beginning of 1994 was about 7 per cent. By the same token, the 1994 change was the last step in a cumulative devaluation that did total about 30 per cent from 1990 to 1994.[c]

The four South-East Asian countries that have borne the brunt of the currency crisis – Indonesia, Malaysia, the Philippines and Thailand – pegged their currencies fairly closely to the dollar. As a result, the pattern that the yuan traced against the dollar was largely also traced vis-à-vis the South-East Asian currencies in the period 1990-1994, cumulating to a 30 to 40 per cent devaluation of the yuan against each of these currencies.

However, the inflation rate in China was higher than in the four above-mentioned countries in this period, and thus, correcting for the different rates of inflation, the changes in the "real" exchange rates between the yuan and the currencies of these economies differed from the changes in the nominal rates. The accompanying figure thus shows the real exchange rate of each of the four South-East Asian countries as measured against the yuan. As can be seen from the figure, the South-East Asian currencies appreciated between 20 and 40 per cent against the yuan in real terms from 1990 to 1993. By 1994, however, when China's inflation rate had reached 24 per cent, the degree of appreciation was already beginning to fall. By 1996, the real parities between the yuan and the currencies of three of the four South-East Asian countries had returned almost to the level of 1990 (the exception was the Philippines, which had also had a relatively high rate of inflation).

In sum, to the degree that the exports of China and the South-East Asian countries were competing in third markets, the exchange-rate changes and inflation differentials of these countries did give a net benefit to China in the early 1990s, but that advantage had been largely eroded by 1996 (except in the case of the Philippines).

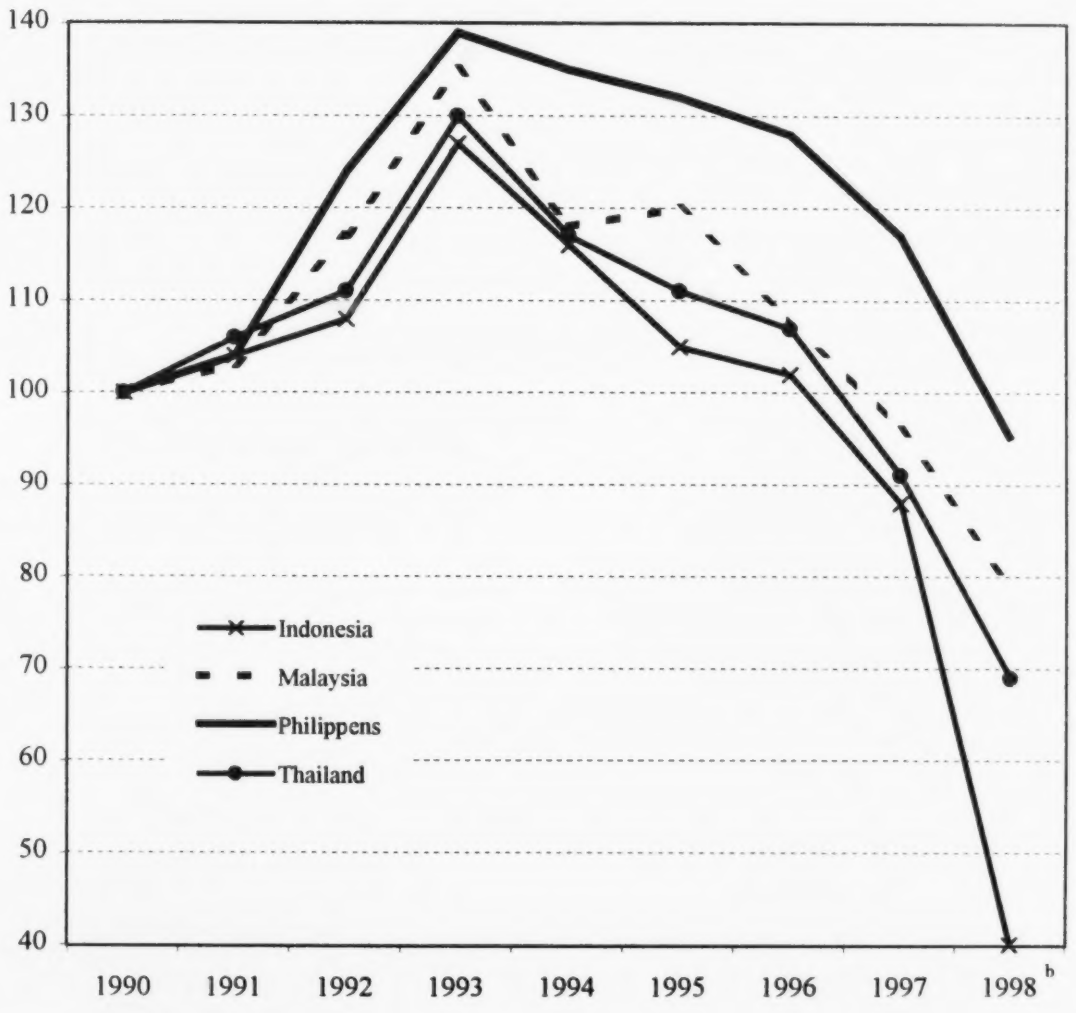
Export competition between China and South-East Asia

The very sharp devaluations of the South-East Asian currencies in 1997 and early 1998 and the expected inflation differentials and exchange-rate movements this year appear to be producing a significant cost advantage for China's competitors. It is not clear, however, how sensitive the competition is to price changes; at least it appears that econometric evidence at the aggregate level is largely inconclusive.[d] This notwithstanding, some observers have argued that there is a close correspondence between the commodity composition of the exports of China and that of the exports of the crisis countries, so price competition might be important, even if the behaviour of trade at the aggregate level is ambiguous.

The accompanying table illustrates the kind of evidence on which the claim of competition is based. It shows the five largest export categories of each country in 1996, in terms of the United Nations Standard International Trade Classification (SITC) system. For example, China's largest export category, SITC 84 (articles of apparel and clothing accessories), was the fourth largest export category of Indonesia and the third largest for the Philippines and Thailand. The top five categories taken together accounted for 47 per cent of China's exports in 1996 and for 45-70 per cent of the exports of the other countries. Each of the five largest export categories of China was also on the list of the five largest exports of one or more of the other four countries. Moreover, extending the exercise to the top 10 export categories at the two-digit SITC level reveals that 8 of China's 10 largest categories were also on the list of the top 10 of the four other countries and these 8 product categories accounted for 57 per cent of China's exports. By this analysis, it thus appears that there is a case to be made for a Chinese devaluation to restore the competitiveness that may have been lost through the crash of the South-East Asian currencies.

Real exchange rates of four Southeast Asian countries against the Chinese yuan renminbi, 1990-1998[a]

(Index: 1990 = 100)



[a] Measured as yuan per unit of South-East Asian currency, adjusted for differences in the annual changes of consumer prices in each country.

[b] Forcast of Project LINK.

Five largest categories of exports of China and four countries in South-East Asia, 1996

(Two-digit trade categories[a])

Rank by value	China	Indonesia	Malaysia	Philippines	Thailand
1	84	33	77	77	77
2	89	63	76	75	75
3	65	34	75	84	84
4	77	84	33	76	03
5	76	65	42	05	89

Source: UN/DESA

Note: Bold-face indicates trade category that is also one of five top Chinese categories.

[a] As per *Standard International Trade Classification, Revision 3*, Statistical Papers, No. 34/Rev.3 (United Nations publication, Sales No. E.86.XVII.12 and Corr.1 and 2). In particular, the five top categories for China were:

84. Articles of apparel and clothing accessories;
89. Miscellaneous manufactured articles, not elsewhere specified or included;
65. Textile yarn, fabrics, made-up articles, not elsewhere specified or included, and related products;
77. Electrical machinery, apparatus and appliances, not elsewhere specified or included, and electrical parts thereof (including non-electrical counterparts, not elsewhere specified or included, of electrical household-type equipment;
76. Telecommunications and sound recording and reproducing apparatus and equipment.

However, the analysis is quite incomplete. It implicitly assumes that within the two-digit categories, the countries are producing similar goods. In fact, as a general rule China produces relatively greater proportions of the more standardized sub-items, where its lower labour cost overcomes the disadvantage of its lower average skill levels. In addition, in some sectors such as electronics, different components of a product might be produced in different Asian countries, with final assembly in yet another, and thus China's exports would be complements to, rather than substitutes for, other countries' exports.

Certainly, the rapid expansion in China's exports in the early 1990s when it had the exchange-rate "advantage" was not accompanied by any deceleration in the export growth of the South-East Asian countries. Moreover, when the slowdown came in the export growth of South-East Asia in 1996, China's export growth also fell (indeed, earnings grew only 1.6 per cent in 1996). To a degree, then, both China and the other countries have been subject to common international economic factors and these may be more important determinants of fluctuations in export earnings than cross-country competition, especially competition based only on price.

Exchange rate as a policy variable

The implication of the preceding discussion is that a number of Chinese exporters might indeed seek to pressure the Government to devalue the yuan renminbi, although the significance of their complaint at the aggregate level is hard to gauge. The dollar value of China's exports in 1998 is forecast to expand by only 5 per cent, compared with the 21 per cent surge in 1997; but this is mainly a reflection of the slowing growth of income globally and especially in Asia.

The exchange rate, moreover, is a monetary variable that is set for a variety of reasons, trade competitiveness being only one of them. From the perspective of macroeconomic policy makers, the potential complaints of the exporters would have to be weighed against several other considerations, including the very strong current-account position of 1997, the continuing inflow of direct investment nd the large reserve holdings (about $140 billion at end-1997). An additional concern is that a Chinese devaluation at this time might destabilize the economic and financial situation in Hong Kong, China, and in South-East Asia. The Chinese policy makers' concern about competitiveness, moreover, is focused on the longer run and the growth in productivity that their structural reform programme is intended to bring about (see chap. II).

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[a] See, for example, L. Liu and others, "Asian competitive devaluations", working paper 98-2 (Washington, D.C., Institute for International Economics, 1998); John Makin, "Two new paradigms" (Washington, D.C., American Enterprise Institute, October 1997); and N. Roubini, G. Corsetti and P. Pesenti, "What caused the Asian currency and financial crisis?" (New York, New York, New York University, Leonard N. Stern School of Business, 1998).

[b] Hassaneli Mehran and others, *Monetary and Exchange System Reforms in China: An Experiment in Gradualism*, Occasional Paper, No. 141 (Washington, D.C., IMF, 1996), pp. 55-63.

[c] Assuming linear increments of the proportion of trade under the market exchange rate from 20 per cent in 1987 to 80 per cent in 1993, and taking account of actual changes in the average swap rate.

[d] For example, a recent study found that the elasticity of substitution between Chinese exports and those of the four South-East Asian countries ranged between 0.3 and 2 (see Y. Inada, L. Klein and J. Makino, "A retrospective view of the Asian financial crisis: special reference to exchange-rate policy", working paper (Philadelphia, Pennsylvania, University of Pennsylvania, 1998).

In any event, the export growth in the crisis countries of East Asia through the first quarter of 1998 has disappointed expectations. The anticipated upturn in exports resulting from the substantial depreciation of the currencies of the crisis countries has not materialized. Supply constraints arising from a lack of short-term financing and the high cost of imported inputs have been obstacles. More importantly, the persistent economic weakness of Japan and the sharp deceleration of economic growth in the region have sharply cut back the demand for exports from the crisis countries. As exports to Japan and intraregional exports account for 10 per cent and 40 per cent, respectively, of total exports of South and East Asia as a whole (see table A.15), this is exerting a significant drag on exports of the countries in crisis and their neighbours. Indeed, intraregional trade, which grew rapidly in the 1990s and provided strong impetus to export growth in the region, is expected to stagnate or even decline in 1998. In addition, some of the economies in the region remain significant exporters of commodities and are being hit as well with declining fuel and non-fuel commodity prices.

International petroleum market

The average price of oil declined by almost 8 per cent in 1997 to about $18.7 a barrel, reflecting a combination of factors, some related to market fundamentals and others to market speculation.[2] As a result, oil export revenues of the member countries of the Organization of the Petroleum Exporting Countries (OPEC) are estimated to have declined

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[2] The price indicator employed here is the average spot price of the OPEC basket of seven crude oils.

by over $5 billion in 1997 despite a significant increase in the oil export revenues of Iraq (see table A.38).

The price of oil had reached a post-Gulf war high in the fourth quarter of 1996, owing to low oil inventories and fast-rising demand. The partial resumption of oil exports from Iraq in December 1996, under the "oil-for-food" programme of the United Nations Security Council (Council resolution 986 (1995)),[3] combined with a steady build-up of oil inventories, put an end to the run-up in oil prices (see figure III.2). The price declined sharply by the end of the first quarter of 1997 and remained almost steady in the second and third quarters of the year. In the fourth quarter, however, prices rose temporarily, reflecting the uncertainty generated by the crisis over the United Nations inspection team in Iraq. That heightened market tension and pushed prices higher before their slipping down in December and in the first quarter of 1998 to levels reminiscent of the mid-1980s. By March the price was under $13 per barrel.

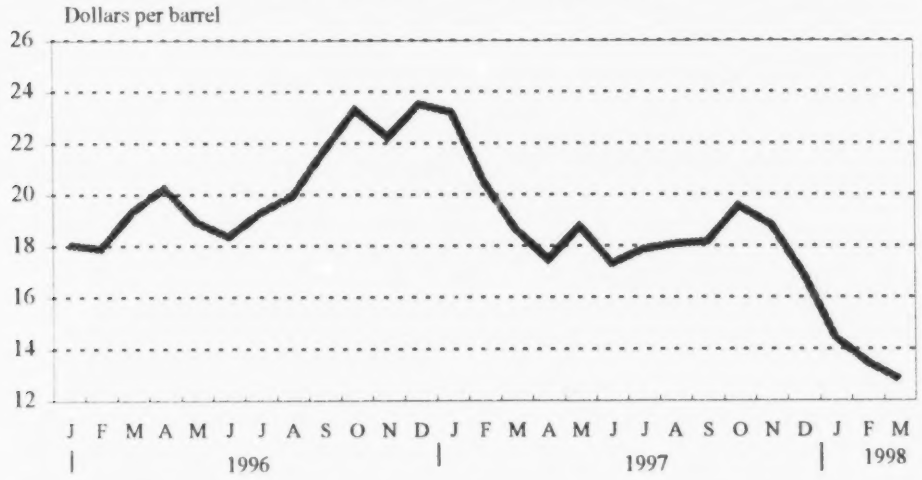
The fall in oil prices since December 1997 was triggered by the decision of OPEC to raise its total output ceiling for the first time in almost four years. OPEC members agreed to raise their production ceiling by 10 per cent to 27.5 million barrels per day during their November 1997 ministerial meeting. The increase, which took effect on 1 January 1998, was allocated on a pro rata basis, in which all country quotas were raised by the same percentage. This decision coincided, however, with an unusually warm winter in the northern hemisphere, which dampened demand for home-heating oil. It also coincided with the decision of the United Nations Security Council on 20 February 1998 to allow Iraq, under Council resolution 1153 (1998), to export up to $5.256 billion worth of oil and oil products every six months, up from the previous limit of $2 billion. Furthermore, the financial crisis that hit most of the South-East Asian economies has lowered growth in the demand for oil. As a result, global oil demand did not keep up with the pace in supply growth from both OPEC and non-OPEC sources, leading to the erosion of prices.

World oil demand increased by 1.7 million barrels per day, or 2.4 per cent, in 1997 (see table A.36). Oil consumption in the economies in transition grew for the first time since 1988. As usual, however, most of the growth in demand was accounted for by the developing countries, where consumption grew by about 5 per cent. Nearly two thirds of the growth in world demand came from the developing countries of Asia. Oil demand in the Republic of Korea (whose economic crisis did not erupt before the end of the year) overtook that of Italy to become the sixth largest in the world, just behind that of the Russian Federation. Growth in oil demand in the developed countries was also relatively buoyant, reflecting strong economic growth in the United States.

The growth of oil production in 1997 was, as noted above, even stronger than the growth in demand. World oil production rose by 2.3 million barrels per day in 1997, that is to say, it was 3.2 per cent higher than in 1996 (see table A.37). Almost all of the growth was accounted for by developing countries, with significant contributions from Argentina, Brazil, Equatorial Guinea, Mexico, Oman and the Russian Federation. Crude oil production from the North Sea reached a new high, approaching 6.2 million barrels per day. Production from Norway, the world's second largest oil exporter, peaked at about 3.3 million barrels per day in 1997. Total production from OPEC, including natural gas liquids, rose by 5.2 per cent, with the largest volume increments from Venezuela (up 8.2 per cent), Qatar (up 26 per cent) and Nigeria (up 6 per cent). As noted above, Iraq exported limited amounts

[3] Under the terms of Security Council resolution 986 (1995), Iraq was allowed to export $2 billion worth of oil for humanitarian needs every six months.

Figure III.2
Average spot prices of OPEC basket of crude oils, January 1996-March 1998



Source: Data of the Organization of the Petroleum Exporting Countries (OPEC).

of oil, but it was enough to double production for the year. The reversal of the earlier sharp decline in production in the successor States of the former Union of Soviet Socialist Republics helped propel non-OPEC oil production to an all-time high of 44.3 million barrels per day.

In this environment and faced with the prospect of no quick rebound from the low oil prices, Saudi Arabia, Venezuela and non-OPEC member Mexico agreed to reduce their exports. The agreement, which was reached on 22 March 1998 in Riyadh, Saudi Arabia, was later supported by other non-OPEC oil-exporting countries, including Norway, and ratified by the OPEC oil ministers at an extraordinary conference held in Vienna on 30 March. At that meeting, OPEC members approved cuts in production totalling about 1.25 million barrels a day. The agreement marked the first occasion in the 1990s when members from OPEC and non-OPEC oil exporters agreed to cooperate in cutting production in order to shore up sagging oil prices.

While the sharp rise in oil output in recent months has been used, to a large extent, to increase desired inventories, the surge in oil supplies will continue to outpace the growth in oil demand. In other words, the increasing oil exports from Iraq and continuing growth of output from non-OPEC producers are expected to leave oil markets soft. Thus, oil prices in 1998 are expected to remain within a range of $13 to $17 a barrel and average under $15 a barrel for the year.

Taking a longer-term view, the marked growth in non-OPEC production in recent years reflected significant advances in petroleum technologies and better management, which have reduced exploration and production costs and made the development and production of oil from previously marginal and out-of-reach offshore oilfields profitable. Oilfields in Alaska, Canada and the North Sea are traditionally considered the most costly to develop. That was the case in the 1970s and 1980s; but in recent years, costs have gone down so drastically that oil prices would have to drop much below $10 a barrel before production became no longer profitable. Meanwhile, non-OPEC oil supply has become increasingly diverse, with new production coming from a number of developing countries.

While aggregate non-OPEC supply is expected to continue rising, especially from a number of developing countries, the call on OPEC oil will also increase, albeit most significantly after the year 2000. A significant part of this increase will come from the Persian Gulf, as well as Venezuela and Algeria.

Non-oil commodity prices weaken

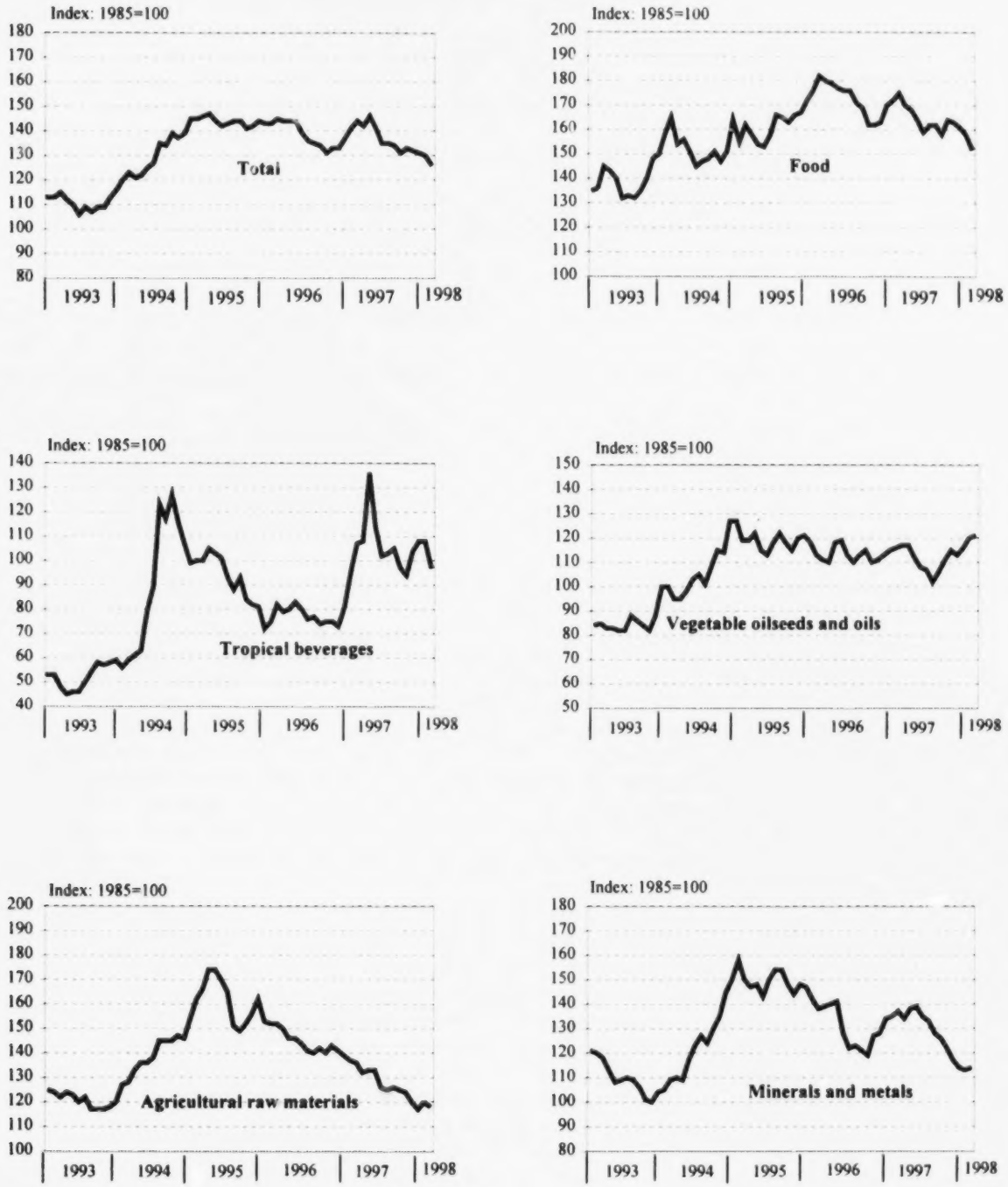
Dollar prices of non-oil commodities exported by developing countries were on average the same in 1997 as in 1996, although there was considerable variability in prices of individual commodities and commodity groups (see table A.19). There was also a pattern in a number of commodities of strong growth in demand and prices at the beginning of the year, followed by declines in the second half (see figure III.3), related in large measure, but not exclusively, to the Asian currency and economic crisis. The annual commodity price index increased by 4 per cent, however, when prices are expressed in special drawing rights (SDRs), a composite currency and unit of account of the International Monetary Fund (IMF). The increase reflects the appreciation of the dollar vis-à-vis the currencies of other industrialized countries and thus an improvement in the purchasing power of commodity export receipts denominated in dollars. This may be seen as well in terms of the purchasing power of exports over manufactured goods exported by the industrialized countries. When measured in these terms, the commodity price index increased by 6 per cent.

Tropical beverages, among the major commodity groups, registered the largest increase in 1997. Prices of the three commodities in this group (cocoa, coffee and tea) increased by 10 per cent or more. Coffee prices increased by over 30 per cent on average for the year. Prices were at high levels in the first half of the year (this has been attributed to supply shortages in major producing countries and high demand in consuming countries) but declined steadily during the second half as global supplies caught up with market demand. The price index of minerals, ores and metals increased by less than 1 per cent, with only aluminium, zinc, iron ore and manganese ore in this group posting higher prices (in the case of zinc, this was an increase of close to 30 per cent for the year as a whole). Prices of copper, lead, nickel and zinc declined considerably from July to December 1997 (and continued falling into the first quarter of 1998) as a result of global excess supplies resulting from the Asian economic crisis. The price index of agricultural raw materials declined by 11 per cent, largely as a result of large price declines for lumber and natural rubber in the second half of the year, a consequence also of the effects of the Asian crisis on markets for those commodities. Average price levels both of the food group and of the vegetable oils and oilseeds group declined by less than 5 per cent in 1997, although there were large declines in prices of some food commodities such as maize, rice and wheat and several of the vegetable oils and oilseeds.

The most unexpected development in 1997 concerning commodity markets was the Asian economic crisis and economic weakening of Japan. Although supply and demand responses to the crisis differed in each country, the downturn in economic activity in East Asia contributed to lower demand for commodity imports, global excess supplies and lower prices. Import demand for industrial raw materials and other commodities slowed considerably in Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand. Demand for raw materials also weakened in several other Asian countries, such as China and Hong Kong, China, that were less seriously affected by the crisis. Industrial growth and strong import demand in Europe, Latin America and the United States averted steeper declines in prices of some commodities in the minerals, ores and metals group.

Large depreciations of the currencies of several of the Asian countries stimulated increases in supplies and lowered prices of commodities such as cocoa, coffee, lumber,

Figure III.3
Dollar indices of non-fuel commodity prices, 1993-1998



Source: UNCTAD, *Monthly Commodity Price Bulletin.*

tin, natural rubber and rice. Indonesia, however, found it necessary to restrict exports of crude palm oil from November 1997 and banned them altogether during the first quarter of 1998. Its aim was to conserve domestic supplies and reduce the need for more costly imports.

Export revenues declined in African and Latin American countries that have become major suppliers of primary commodities to East Asian countries in recent years as a result of lower prices and sales volumes. Exports from South Africa and other Southern African countries of minerals, ores and metals – including gold, diamonds, platinum, copper, nickel and zinc – to South-East Asia fell considerably during 1997 and continued falling during the early months of 1998. Chile's earnings from copper exports in 1997, a third of which usually go to Japan and other Asian countries, improved by less than 1 per cent, because of the contraction in demand and fall in prices during the second half of the year.

Unfavourable weather attributed to the El Niño phenomenon also affected commodity markets and prices in 1997 although the effects were not as disruptive as had been widely anticipated. Coffee exports fell by as much as 50 per cent in some countries in Eastern Africa that had experienced heavy, unseasonable rains which destroyed crops and transportation infrastructure to and from farms. In Indonesia, severe drought, attributed to the El Niño effect, caused a drop in output of export commodities such as coffee, cocoa and natural rubber; but in Southern Africa and elsewhere, growing conditions were generally normal for both domestic food crops and agricultural exports. Nevertheless, plantings and crop yields in South Africa and Zimbabwe were reduced as much as 20 per cent below normal because of strong and persistent predictions that the El Niño weather pattern was going to cause severe drought in the region and wreak damage on the same devastating scale as in the 1982/83 crop year.

Internationally as well as domestically, commodities continue to be a focus of policy makers. International commodity agreements for cocoa and coffee have been renewed in recent years but without their earlier provisions for price support schemes such as buffer stocks and export controls. In March 1998, however, member countries of the International Cocoa Organization (ICCO) reached agreement on a "Cocoa Production Management" plan, under article 29 of the 1993 International Cocoa Agreement. The plan sets specific targets for cocoa production, consumption and stock levels that would reduce excess supplies and maintain stable supply and demand balances worldwide. ICCO predicts that cocoa prices will rise substantially during the four-year implementation phase of the agreement. A similar arrangement among aluminium producers over the past three years – through a memorandum of understanding, rather than the formal, legally binding arrangement of an international commodity agreement – has been successful in introducing some degree of stability to the aluminium market.

Major member countries of the Association of Coffee Producer Countries (ACPC) have also set limits on coffee exports. However, weather-related production shortfalls and strong demand in producing countries, rather than the export retention scheme, accounted for most of the price increases during the periods of high prices in the past two years. Moreover, several low-income, commodity-dependent countries among the major coffee producers usually ignore agreed export limits in order to benefit from foreign exchange windfalls when prices are favourable.

The International Natural Rubber Agreement (INCA) entered into its third cycle in February 1997, with a membership comprising the 6 exporting countries that account for 99 per cent of global output and 16 consuming countries, including major importers such as EU and the United States. INCA is the only international commodity agreement with a buffer stock arrangement. In April 1997, natural rubber prices dropped to their lowest

levels in 36 months, albeit not low enough to trigger intervention buying under the buffer stock scheme. Since then, dollar prices have continued to fall; but because the INCA agreement is based on prices in Malaysian ringgit, and with the ringgit having fallen against the dollar, the intervention mechanism had still not been invoked as of April 1998.

Financial instruments linked to commodity trade have also drawn the attention of policy makers. Trade in commodity futures and other derivative instruments linked to commodities have periodically caused price volatility in commodity markets. Two of the most highly publicized incidents in recent years have been the collapse of Bares, Public Limited Company, in 1995 and the Semidome incident in 1996 which led to huge losses for the parent corporations and traders in the copper market.[4] Since the occurrence of those two incidents, regulatory agencies in several countries have sought to introduce measures to enhance international supervision of global financial and commodities markets.

A significant step in that direction was taken in October 1997 when representatives of regulatory agencies in Japan, the United Kingdom of Great Britain and Northern Ireland, the United States and several other countries adopted a set of principles that amounted to international standards for the supervision of commodity derivatives markets.[5] The agreement incorporates regulatory benchmarks based on commonly acknowledged "best practices" in the design of derivatives contracts, market surveillance and information-sharing among regulatory agencies to detect potentially destabilizing market positions and trading practices. There was also a commitment to seek harmonization of national legislation so as to achieve full implementation of the agreement.

Preferential trade and trading arrangements

Governments, particularly of developing countries, have periodically sought to create new regional trading arrangements, the 1990s being a particularly fecund period. Some of these arrangements have led to strong growth in trade, while others have been less productive; but as developments in 1997 and early 1998 indicate, they remain very much a focus of the attention of policy makers.

Latin American successes in the 1990s have been particularly noteworthy, including creation of the Southern Cone Common Market (MERCOSUR) and a series of bilateral agreements, as well as the reactivation of the Andean Pact and the Central American Common Market. The new Latin American arrangements were also said to have set the stage for complementary regional infrastructure projects; but the sense of success lay less in the formal establishment of these arrangements than in the surge in intraregional trade with which they have been associated. In 1997 in particular, the dollar value of intraregional trade grew 17 per cent, compared with an 11 per cent increase in Latin American exports to the rest of the world.

Recently, moreover, the process of Latin American integration took several steps forward. The Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) agreed to move from the free trade agreement established in 1996 to a common market by

[4] On the former, see United Nations Conference on Trade and Development (UNCTAD), *Trade and Development Report*, 1995 (United Nations publication, Sales No. E.95.II.D.16), part two, chap. III, especially footnotes 37 and 40, which point to the importance of the Bares case in the issue of systemic risk and derivatives markets. On the Semidome incident, see *World Economic and Social Survey, 1997: Trends and Policies in the World Economy* (United Nations publication, Sales No. E.97.II.C.1 and corrigenda), chap. III, subsect. entitled "Commodity prices and markets".

[5] Remarks of Brooksley Born, Chairperson, Commodity Futures Trading Commission (CFTC) before the Exchequer Club ("The CFTC's international initiatives in a global marketplace", 17 December 1997 (http://www.cftc.gov/opa/born-25.htm). Accessed on 27 April 1998).

2005. The Andean Community and MERCOSUR (Argentina, Brazil, Paraguay and Uruguay) agreed on a calendar for setting in motion a free trade agreement by the year 2000. The Andean Community signed a framework agreement with Panama, as a first step towards a free trade agreement and, eventually, its full incorporation into the Community. MERCOSUR and the Andean Community agreed to include Chile in the first phase of their integration plans, which entails extending to all member countries the preferences that they have granted each other bilaterally. Finally, MERCOSUR and the Central American Common Market (comprising Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) agreed to set in motion a tariff reduction programme, as a first step towards a free trade agreement.

The motivation for establishing such preferential trading areas (PTAs) has been both political, as Governments in Latin America sought to reduce traditional tensions among neighbours, and developmental, as Governments adopted more outward-looking strategies that pushed them to seek trading opportunities beyond those perceived to exist with traditional trading partners. Latin American countries were in any case reducing overall trade barriers and so the preferential arrangements have mainly represented a relatively more rapid reduction in the barriers to partner trade.[6]

In South-East Asia, in contrast, trade liberalization has been undertaken almost entirely in a non-discriminatory manner and intraregional trade mushroomed anyway. The commitment of member States of the Association of Southeast Asian Nations (ASEAN) to establish first a PTA and then a free trade area (FTA) produced agreements that have affected only a small percentage of intra-ASEAN trade.[7] Little basis was said to have existed for negotiating mutual trade concessions in ASEAN since Singapore had no tariffs to begin with and Malaysia had low ones and thus neither country could offer significant trade concessions in exchange for preferential access to the markets of the other countries.

Similar considerations seem to be at play in the trade liberalization strategy of the larger grouping of countries that make up the Asia-Pacific Economic Cooperation (APEC) Forum.[8] Members of APEC have pledged to reach "free trade" by 2010 for developed countries and 2020 for developing countries, using a process called "concerted unilateralism".[9] Each country develops individual action plans for trade liberalization in consultation with other members and collective action plans are also agreed. Progress in implementation and updating of these plans is to be reviewed annually, the first review having taken place at the November 1997 Vancouver APEC Summit. This is seen as an alternative "Asian" strategy for trade liberalization, to be contrasted with the trading of concessions that characterizes the standard multilateral negotiations on trade.[10]

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[6] See Robert Devlin and Ricardo Ffrench-Davis, "Towards an evaluation of regional integration in Latin America in the 1990s", paper presented to the Forum on Debt and Development (FONDAD) Conference on Regional Economic Integration and Global Economic Cooperation: the Challenges for Industrial, Transitional and Developing Countries, The Hague, 18 and 19 November 1997.

[7] Members of ASEAN include Brunei Darussalam, Indonesia, the Lao People's Democratic Republic (as of 1997), Malaysia, Myanmar (as of 1997), the Philippines, Singapore, Thailand and Viet Nam (as of 1995).

[8] Membership includes the five original members of ASEAN and Brunei Darussalam, plus Australia; Canada; Chile; China; Hong Kong, China; Japan; the Republic of Korea; Mexico; New Zealand; Papua New Guinea; Taiwan Province of China; and the United States. In addition, Peru, the Russian Federation and Viet Nam are designated to become full members in November 1998.

[9] That the precise meaning of "free trade" has not been defined by APEC reflects a further dimension of flexibility in APEC processes.

[10] Address of Dr. Narongchai Akrassanee, Minister of Trade of Thailand, "APEC process of international trade and investment flows in Asia and the Pacific", presentation to a workshop of the Economic and Social Commission for Asia and the Pacific (ESCAP) Bangkok, 19 September 1997.

There is a general point being made in the eschewing of preferential trade agreements in Asia, whereby it can be formally demonstrated that a preferential reduction of trade barriers between high-tariff and low-tariff countries benefits the latter at the expense of the former. The essence of the argument is that the high-tariff countries give up tariff revenue, which is absorbed in the higher costs and profits of the still-protected and thus less-than-globally-competitive exports of the low-tariff countries.

This argument applies, for example, to the proposed free trade area of the Americas (FTAA), as North American trade barriers are generally far lower than those in Latin America. The "static" trade losses of the Latin American partners, however, are to be offset by "dynamic" trade gains.[11] Thus, in April 1998, at the second Summit of the Americas, leaders of 34 countries in the western hemisphere formally set in motion the process designed to lead to the establishment of FTAA by the year 2005. If successful, this would constitute the world's largest free trade area, with over 770 million people and a combined GDP of about $9 trillion.[12]

A somewhat similar concern about economic integration between countries of very unequal size has arisen with respect to the role of South Africa in an FTA of the Southern African Development Community (SADC).[13] The 1996 Trade and Development Protocol, which had largely been negotiated before South Africa joined SADC, would make a symmetric and quick (eight-year) march to free intra-SADC trade. One concern was that this would serve largely to deindustrialize South Africa's partners. Instead, it has been argued, South Africa should reduce its own trade barriers vis-à-vis its SADC partners more rapidly than the other SADC countries, giving them more time to adjust their capacities to compete.[14]

This concern notwithstanding, the strong growth of South Africa's trade and investment in the SADC region and the flourishing trade among other countries in SADC have provided an important impetus to economic growth in member countries. South Africa's investment in the region since 1995 includes infrastructure projects, worth 45 billion rand, to set up economic corridors linking that country to Botswana, Namibia and Mozambique, and substantial expenditure on hydroelectric, water and mining projects in Mozambique. Also, labour-intensive clothing factories have relocated from South Africa to Lesotho and Malawi. Moreover, SADC member countries have set a deadline of 30 June 1998 for the ratification of six non-trade protocols in other areas of development cooperation, which include shared watercourses, energy, drug trafficking, transport, communication, meteorology, mining, education and training.

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[11] There is a controversy about how large these gains might be, especially compared with the dynamic gains that would accrue from a non-discriminatory liberalization of trade (see Arvind Panagariya, "The Free Trade Area of the Americas: good for Latin America?", *The World Economy*, vol. 19, No. 5 (September 1996), pp. 485-515).

[12] The prospects for negotiations, however, are unclear, as the negotiators for the United States have not received "fast-track" authority from the United States Congress. This means that, instead of the negotiated package being accepted or rejected as a whole, every specific commitment by the United States Administration would be subject to veto by the Congress, thereby making it virtually impossible to negotiate any exchange of concessions with trading partners.

[13] Member countries of the Southern African Development Community (SADC) include Angola, Botswana, the Democratic Republic of the Congo (formerly Zaire), Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, the United Republic of Tanzania, Zambia and Zimbabwe.

[14] See Rosalind H. Thomas, "A South African perspective on the SADC Trade and Development Protocol", background document for the FONDAD Conference on Regional Economic Integration and Global Economic Cooperation: the Challenges for Industrial, Transitional and Developing Countries, The Hague, 18 and 19 November 1997.

Among the other regional associations of African countries, there were important developments recently in the East African Cooperation (EAC) of Kenya, Uganda and the United Republic of Tanzania.[15] In 1997, EAC formalized arrangements to harmonize several aspects of fiscal and monetary policy, including an arrangement to avoid double taxation, collaboration in the preparation and review of budget estimates, and coordination of banking, capital account and securities regulation. EAC also announced joint investment projects in industrial development, upgrading and modernization of infrastructure (a regional road network and installation of modern telecommunications facilities) and measures to enhance the free movement of nationals of each country across their respective national borders. The cooperation arrangement is expected to be converted into the East African Community (including a monetary union with a common currency). A formal treaty is expected to be ratified before the end of 1998.

In addition, the Common Market for Eastern and Southern Africa (COMESA),[16] the largest subregional group in Africa, adopted a common external tariff structure and a common monetary unit (the COMESA dollar, linked to the United States dollar) for the settlement of trade debts, as further measures to expand markets and trade among member countries. Intra-COMESA trade, however, accounted for only about 6 per cent of total trade of member countries and was dominated by only a few countries – Kenya, Madagascar, Uganda, the United Republic of Tanzania, Zambia and Zimbabwe – with the highest concentration being among the three members of EAC. Moreover, regional conflicts and civil strife in several member countries (including Burundi, the Democratic Republic of the Congo (formerly Zaire), Rwanda, Somalia and the Sudan) presented difficulties in regard to the implementation of development cooperation in industry, agriculture, transport and communications.

Similar concerns have pertained in South Asia, where intraregional trade was only 4 per cent of total trade (although this excluded a large amount of contraband trade). Despite the creation in 1985 of the South Asian Association for Regional Cooperation (SAARC)[17] and its PTA in 1993, members have routinely barred some trade flows. In recent years, however, the region's leaders sought to reduce regional military tensions and saw more rapid movement towards an FTA as helpful. They thus produced more extensive (albeit still limited) implementing agreements towards an FTA in 1997. On economic grounds alone, according to the World Bank, it could be argued that unilateral trade liberalization would be a superior policy choice. However, the intensification of regional cooperation in South Asia was warranted on broader considerations, above all as a "step towards better political relations – and peace".[18]

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[15] For selected developments in regional groupings in Western and Central Africa, see box III.2 below.

[16] Member countries of COMESA are Angola, Burundi, the Comoros, the Democratic Republic of the Congo, Djibouti, Eritrea, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique (membership in suspension), Namibia, Rwanda, Seychelles, Somalia, the Sudan, Swaziland, Uganda, the United Republic of Tanzania, Zambia and Zimbabwe.

[17] Member countries of the South Asia Association for Regional Cooperation (SAARC) are Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

[18] See Miria Pigato, "Regional integration in South Asia" (background document for the FONDAD Conference on Regional Economic Integration and Global Economic Cooperation: the Challenges for Industrial, Transitional and Developing Countries, The Hague, 18 and 19 November 1997), p. 6.

International finance and the net transfer of resources

International lending on the world's capital markets broke yet another record in 1997, when over $1.2 trillion in new medium- and long-term bonds and bank loans were arranged for non-resident borrowers. Since 1991, international borrowing arrangements have grown almost 18 per cent a year (see figure III.4); and this does not even include the growth of foreign holdings of equity shares or other types of private international financial flows, which have also grown rapidly. However, while total flows continue to increase, fewer countries are able to tap them (or tap them on tougher terms), largely as a consequence of the Asian financial crisis.

Over 80 per cent of the medium- and long-term credit arrangements included in figure III.4 were for borrowers from developed economies and most of those were for the private sector; but arrangements for public and private borrowers in developing countries rose over 25 per cent in 1997 and arrangements for transition economies, albeit of a much smaller magnitude, grew 160 per cent. In short, there is no shortage of financial resources in international capital markets and the markets are able to intermediate the very large flows with ease.

At the same time, however, 1997 saw the greatest number and value of bond defaults globally since the 1930s.[19] There were defaults by at least 64 issuers of publicly held corporate debt in 1997 on bonds nominally valued at $8.6 billion.[20] compared with defaults by 26 issuers on bonds valued at $4 billion in 1996. Two thirds of the 1997 default activity occurred in the second half of the year, reflecting the currency crisis in East Asia and the continuing financial difficulties in Japan. Indeed, 22 defaults of Asian domiciled firms were registered in 1997; previously, only one such default had been recorded since the Second World War.

The default data, coupled with lowered assessments of developing-country creditworthiness, began to be reflected in sharply reduced international lending to developing countries in the closing months of 1997 and in early 1998. In addition, the risk premiums built into the interest rates on developing-country bonds rose, in some cases dramatically, although by March 1998, the "spreads" had already receded substantially in many cases.[21]

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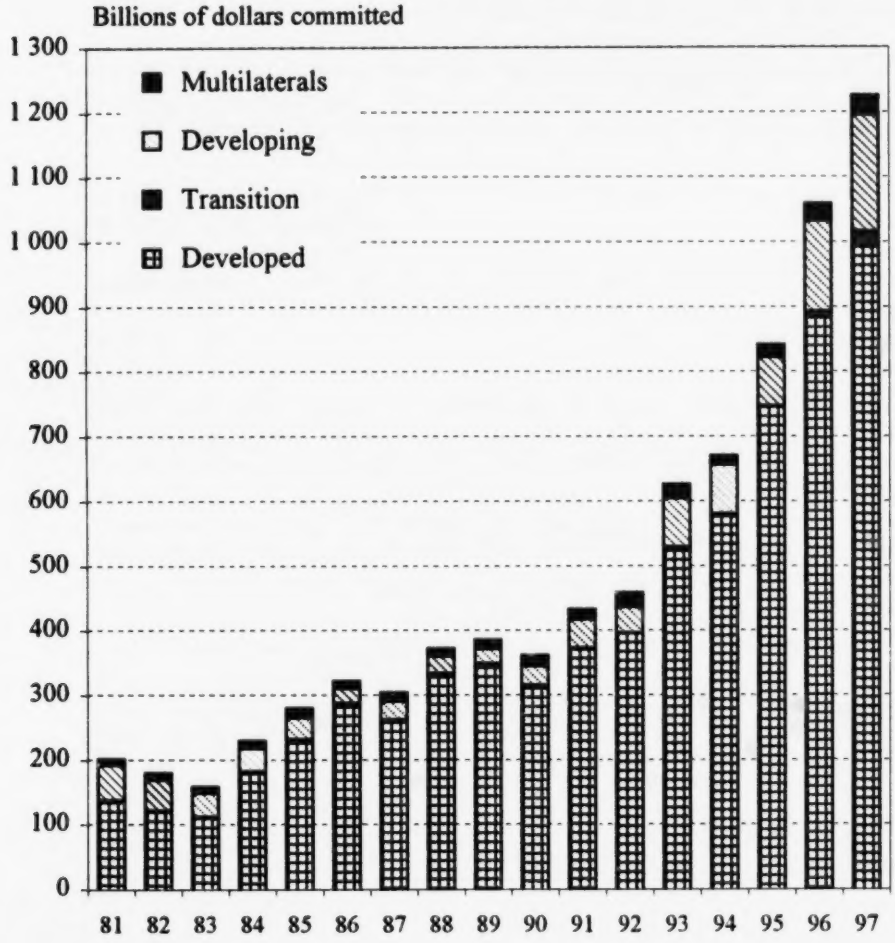
[19] The coverage of these data is perforce incomplete, especially as regards privately placed and unrated credits; in addition, those data do not include the closure by financial regulators of 74 banks and financial institutions in Indonesia and Thailand in 1997, as this did not entail defaults on obligations held by public bondholders (see Moody's Investors Service, "Historical default rates of corporate bond issuers, 1920-1997", special comment, February 1998).

[20] Even the 1997 default figure, however, is a tiny fraction of global bond issuances in a year, let alone of the outstanding stock; but bond buyers expect the probability of default to be extremely low, especially for bonds that are rated by rating agencies in major markets.

[21] For example, spreads over United States Treasury bond yields on Brazilian debt rose from under 4 percentage points in September 1997 to over 6 percentage points in October, but fell back almost to 4 percentage points by March 1998; spreads on Philippine debt rose from under 2 percentage points in June 1997 to 4 percentage points by October and eased back but were still above 3 percentage points in March 1998; spreads on the debt of crisis countries had larger swings (see Institute of International Finance, *Capital Flows to Emerging Market Economies* (Washington, D.C., 30 April 1998), pp. 7-8).

Figure III.4
International market lending, 1981-1997[a]



Source: Data of Organization for Economic Cooperation and Development (OECD), *Financial Statistics Monthly*.

[a] Sum of foreign and international bonds, syndicated loans and other debt facilities arranged.

This notwithstanding, the sentiment in the international financial market seemed to be that most medium- and long-term funding for projects in countries in crisis would be restricted to projects that were already in the pipeline, were structured so as to generate an assured cash flow to repay creditors in foreign currency, and had credible local sponsors, preferably as equity partners. Private international financing for new "greenfield" projects would be hard to arrange in some countries for some time.

In other words, certain countries were being thrown back onto a reliance on official financing, as the middle-income countries in debt crisis in the 1980s had been. Moreover, the first large-scale officially encouraged "voluntary" restructuring of commercial bank debt since the 1980s debt crisis was arranged (in this case, it was for the Republic of Korea). There are many other countries, however, that have not yet gained significant access to private financial markets in the first place. They continue to rely on increasingly restricted supplies of concessional official flows.

International transfer of financial resources

The two most striking developments in the international flow of financial resources in 1997 were that the net transfer to the United States rose to $131 billion, the highest level in a decade (see table A.24), and that the developing countries as a group saw an extraordinary swing from a small net transfer to them from other countries (denoted as a positive net transfer) in 1996 to a net transfer from them to other countries (denoted as a negative net transfer) in 1997 (see table III.1). In part, both these developments were caused by the changes in international trade discussed above, as the "net transfer" to a country is an expression of the financing of its trade deficit (or the disposition of its trade surplus). By the same token, the trade flows were not independent of major developments in international financial flows, as the net transfer of resources is the interface between the trade and financial sides of the balance of payments.[22]

In the case of the United States, one aspect of the very large net transfer was an extraordinary $309 billion inflow of portfolio investment (see table A.24). This appears to have embodied the "flight to quality" that was observed in the financial markets when the Asian crisis disrupted financial investor confidence around the world. Most of the inflow comprised foreign net purchases of United States debt securities, both Treasury securities ($163 billion, excluding foreign official reserve purchases) and corporate and other bonds ($122 billion). In addition, there was an especially strong inflow in the form of net foreign purchases of United States equity shares ($67 billion, compared with $12.6 billion in 1996), taking advantage of the rising United States stock market. On the other hand, net foreign portfolio purchases by United States residents dropped by almost $30 billion in 1997 (which still left almost $80 billion in United States foreign purchases).

The slowdown in United States portfolio outflow, like the increase in inflows, was related both to the relative performance and expectations of different national financial markets and exchange rates and to the uncertainties created by the Asian currency crisis. This was especially visible in the fourth quarter of 1997 when United States residents heavily sold shares in every major foreign market area except Canada. In addition, many non-residents of the United States also moved their deposits from non-United States

[22] A caveat is in order in regard to interpreting international financial flows data: there are very large unrecorded flows and mis-recorded flows (income flows recorded as capital transactions and vice versa, and internationally inconsistent dating of transactions). Thus, whereas the sum of outflows should equal the sum of inflows, making the global net flow zero, the global net flow can be quite large; moreover, the size of the global net flow can change dramatically from year to year (table A.20 illustrates this phenomenon for the current transactions side of the balance of payments).

banking institutions to banks in the United States and outflows of currency from the United States jumped from $17 billion in 1996 to $25 billion in 1997.[23]

Regarding the developing countries, the aggregate net transfer of financial resources was significantly negative in 1997 for the first year since 1990 (see table III.1). The net transfer to the least developed countries was not much changed, nor was that to Africa. If the net transfers to these countries did not suffer a deterioration, neither did they see any significant improvement. Rather, the main development was the sharp increase in the net outward transfer from certain Asian economies, which was only partly offset by the substantial increase in the net transfer to Latin America and the Caribbean. In some cases, such as that of China and some of the small Asian "tigers", the outward transfer was a sign of economic strength, while for others it was the beginning of a difficult adjustment process, as discussed in chapter II.

In the case of China, the net outward transfer was made possible by a large increase in exports, which increased the surplus in China's trade balance. In addition, China continued to receive considerable capital inflows in 1997. Thus, while some of the net outward transfer took the form of interest and other investment income payments, China was also able to add some $35 billion to its foreign official reserves and there was a substantial net addition as well to Chinese commercial bank and other foreign currency assets.

As may be seen in table III.1, a grouping of four exporters of manufactures – the original "newly industrialized economies", or "four tigers" – transferred almost $21 billion in financial resources to other countries. This brings into focus a mixed picture. In the case of the Republic of Korea, an apparent strengthening of its external accounts in 1997 masked a weakness that became apparent as the year ended. The Republic of Korea successfully reduced its unusually large 1996 trade deficit by $12.5 billion, both through export increases (measured in constant prices, merchandise exports of the Republic of Korea grew 25 per cent) and through a contraction of imports in the second half of the year under a sharp economic adjustment policy. This reduced its need for net capital inflows and net financial transfers. Not captured by these data, however, was the loss of confidence in the creditworthiness of many Republic of Korea borrowers and the resulting difficulty at the end of 1997 in obtaining continued rollovers of short-term funding, which triggered the Republic of Korea's crisis.

Regarding the other tiger economies, the trade surpluses – and thus the net financial transfers associated with them – shrank somewhat in Hong Kong, China, and grew in Singapore and Taiwan Province of China. The external financial resources that arose from these trade surpluses were used for direct investment and portfolio outflows, particularly from Taiwan Province of China, or increases in reserves or other foreign assets.

Virtually all the other countries in South and East Asia remained net recipients of resource transfers, albeit with smaller total inflows. Although there were instances of countries in which the net transfer increased, such as India, most countries saw their net transfer shrink. In the crisis countries, notably Indonesia and Thailand, the change was sharp. While data are still incomplete, the extent of the shift is suggested by the improvement in the trade balance, which in Indonesia was about $3.5 billion (mainly export increases) and in Thailand about $6.5 billion (mainly import reductions).

[23] See Christopher L. Bach, "U.S. international transactions: fourth quarter and year 1997", *Survey of Current Business*, vol. 78, No. 4 (April 1998), pp. 51-97.

Table III.1
Net transfer of financial resources of groups of developing countries, 1987-1997[a]
(Billions of dollars)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997[b]
Africa	-3.0	3.9	0.9	-10.1	-5.7	-1.0	2.8	7.8	12.6	2.1	4.7
of which:											
Sub-Saharan Africa[c]	6.3	7.8	6.1	8.8	9.2	11.3	9.8	8.3	7.8	8.4	9.5
Latin America and the Caribbean	-18.6	-22.0	-27.7	-27.5	-8.9	7.8	14.2	17.0	-0.8	-2.4	17.6
West Asia	21.3	23.8	16.6	4.3	50.9	39.5	38.8	10.1	14.7	3.8	-0.2
Other Asia	-32.1	-20.5	-12.5	-10.4	-9.4	-5.6	6.8	-5.6	10.4	4.5	-48.8
of which:											
China	-0.5	3.9	4.9	-10.8	-11.8	-5.2	11.4	-8.0	-12.3	-19.2	-47.3
Four exporters of manufactures[d]	-30.4	-26.8	-21.9	-11.8	-7.8	-8.2	-13.5	-12.4	-7.1	-0.6	-20.7
Other South and East Asia	-1.2	2.4	4.5	12.2	10.1	7.8	8.9	14.8	29.8	24.3	19.1
All developing countries of which:	-32.4	-14.8	-22.8	-43.7	26.8	40.7	62.7	29.3	36.9	8.0	-26.8
Net-creditor countries	-4.0	5.6	0.1	-14.5	18.5	14.4	13.9	-0.7	-9.3	-24.1	-30.7
Net-debtor countries	-28.4	-20.4	-22.9	-29.1	8.3	26.3	48.8	30.0	46.2	32.1	3.9
Memorandum items											
Sample of 105 countries[e] of which:	-26.8	-23.6	-20.5	-25.7	6.9	25.3	49.7	24.9	28.6	17.9	-14.0
Least developed countries[f]	8.2	8.8	8.4	8.7	9.8	11.6	11.6	9.2	11.0	11.2	12.2

Source: UN/DESA, based on data of IMF, official national and other sources (for memorandum items, see table A.25).

[a] Expenditure basis (negative of balance of payments on goods, services and private transfers, excluding investment income).

[b] Preliminary estimate.

[c] Excluding Nigeria and South Africa.

[d] Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China.

[e] One hundred and five net-debtor countries, for which sufficient data are available. For more detailed information, see table A.25.

[f] Covering 42 out of the 48 least developed countries.

The change in the financial flows to a sample of 22 countries from South and East Asia in 1997 showed the crisis in action: the sum of short-term borrowing, stock market net flows, and net outflows from domestic residents, which has usually registered a relatively small net inflow, suddenly grew to an outflow estimated at almost $50 billion (see table A.25). To a small degree, this was compensated by larger inflows of medium- and long-term private credits, but the main counterweight was a large shift in official lending: instead of an outflow (net interest and principal repayments) of about $8 billion a year, as in 1995 and 1996, these countries received $17 billion in net transfers from official creditors in 1997. The increase in these inflows, however, did not fully offset the larger outflows.

Reflecting contagion from the Asian crisis, Latin America and the Caribbean experienced a roller-coaster year in 1997. During the first half of the year, the region was receiving substantial private credit inflows on a net basis, continuing a trend that had started in 1996 owing to low international interest rates and improving growth prospects. As the Asian crisis sent ripples to other emerging markets, however, the growth of credit flows suddenly stopped. For the year as a whole, the net transfer on foreign credit was $11 billion, almost half of the amount recorded in 1996 (see table A.25). In contrast to the situation in Eastern and Southern Asia, however, short-term borrowing and other unidentified flows continued to come into the region on a net basis. Also, foreign direct investment (FDI) inflows swelled, reflecting continuing confidence of transnational corporations in the prospects of the region, despite the volatility associated with external monetary shocks.

One region that seemed largely to escape the financial consequences of the Asian crisis was Africa. Excluding reserve accumulation, the net transfer to 50 African countries increased by $6 billion in 1997, as some countries in North Africa (Algeria, Egypt, Morocco and Tunisia) received a substantial amount of portfolio investment and other forms of long-term capital. It was the first time in the 1990s that disbursements on medium- and long-term private credits to the 50 countries as a group exceeded interest and principal payments on their outstanding credits. The net transfer on foreign investment, however, remained quite weak and the net transfer back to foreign official creditors was barely offset by the shrinking level of official grants (see table A.25).

In the smaller and generally lower-income grouping of sub-Saharan Africa (defined to exclude Nigeria and South Africa in order to better focus on the smaller economies), the financial situation was weaker than in Africa as a whole. While the aggregate net financial transfer to this grouping remained positive, it was smaller than it had been in the early 1990s (see table A.25). The region participated in the increase in private lending to Africa as a whole, as noted above, but new inflows of direct investment were less than the outflows for investment income payments and capital repatriation.

The point of this observation is not that returns to investors on past direct investments should always be less than new inflows, which is not the case, but that the data reflect uncertainty on the part of investors. Enterprise managers make decisions about the future growth of their operations in the host countries when they allocate profits between dividend payments and earnings retained and thus reinvested. In a dynamic economic setting, with perceptions of political and economic stability and growth, one would expect to see relatively small dividend payments and large reinvested earnings, as well as new investment inflows. This is not yet the case in much of sub-Saharan Africa.

In addition, like Africa as a whole, the sub-Saharan grouping has made net interest and principal repayments to official creditors that have exceeded disbursements on new loans, albeit by a small amount, since 1996. The grouping continued to receive a positive overall net transfer from foreign official sources, however, because official grants were

larger than the net transfer back on loans; but it is noteworthy that with shrinking official grants and rising private grants (principally from non-governmental organizations), the dollar value of official grants has now fallen from over six times private grants at the beginning of the decade to little more than two times private grants (see table A.25).

With respect to the transition economies, there are not sufficient data to estimate the full net transfer of resources or its financing; however, from partial evidence there appears to have been a positive net transfer overall since 1996. In other words, there has been an aggregate trade deficit since that year (see table A.22). The positive net transfer, however, has been concentrated in the Central and Eastern European countries and in the Baltic States, as Commonwealth of Independent States (CIS) has maintained a trade surplus.

Aspects of international financing for development

Considerable attention is being paid in various parts of this *Survey* to changes in international private credit flows to developing countries in 1997 and 1998 and the volatility and uncertainty that private flows have engendered (see concluding section of this chapter). There have also been important developments, however, concerning other major categories of international financial flows to developing countries, such as direct investment and multilateral official assistance, and in the treatment of the debt of some of the excessively indebted low-income countries.

Foreign direct investment

Net inflows of FDI to developing countries are estimated to have reached a record level of almost $90 billion in 1997 (see table A.25).[24] This did not represent a large increase over the level in 1996 ($86 billion), but it is a dramatic change from the orders of magnitude before the 1990s surge in investment flows began; for example, in 1990, net direct investment in developing countries was less than $17 billion. FDI is by far the largest component of net financial flows to the developing economies as a group. These flows remain, however, highly concentrated, with almost three quarters of total flows going to the 10 largest recipients – mostly Asian and Latin American countries.

The main factors that have bolstered aggregate FDI flows since the beginning of the 1990s are still in place. Technological development has fostered greater possibilities for the globalization of production and investment. Privatization and the liberalization of terms of FDI, not to mention overall macroeconomic stabilization, have spread to more and more developing countries, creating increasingly attractive and enabling environments for FDI. In addition, strengthened growth of output and incomes in many developing countries, as well as trade, has raised the prospects of long-term profits to be derived from locating in and serving markets in developing-country regions.

Gross direct investment inflows – a different statistical indicator than that referred to above – into Eastern and Southern Asia (including China) were estimated to be about $80 billion in 1997.[25] The impact of the regional financial crisis had thus not yet been felt. Total flows to four of the five most affected countries (Malaysia, the Philippines, Thailand and the Republic of Korea) were almost unchanged from the previous year, although flows

[24] Data pertain to a sample of 105 net-debtor developing countries (see introduction to the statistical annex for further details on the country grouping); they exclude reinvested earnings and are net of direct investment by enterprises from developing countries.

[25] The discussion of gross Asian FDI inflows and outflows draws, in part, on UNCTAD and International Chamber of Commerce, "The financial crisis in Asia and foreign direct investment", background note, March 1998.

to Indonesia declined sharply. Investment flows to China continued to rise and were estimated to have reached $45 billion in 1997.

FDI in the region is expected to be lower in 1998, primarily owing to a marked decline in China. The sharp decline in investment flows coming from major Asian investors (in particular Japan and the Republic of Korea) is a major factor in this reversal. Contrasting pressures are influencing direct investment into the South-East Asian economies. On the one hand, economic conditions are depressed and the outlook is particularly cloudy in certain countries. On the other hand, the prices of assets have dropped very appreciably owing to the bursting of stock market and real estate bubbles, and the cost of production for export has fallen dramatically as a result of large currency depreciation. Moreover, the conditions for long-term growth – relatively well-developed infrastructure and human resources – are still intact.

In addition to the Republic of Korea, other developing countries in Eastern and Southern Asia have recently been sources of FDI. The financial crisis in the region is also reducing their outflows of FDI. This is expected to affect, in particular, investment in the lower-income countries in the region (Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam), which receive large shares of their total foreign investment from crisis-affected countries. Some African countries that have recently become destinations for Asian FDI are also being affected.

Gross FDI inflows into Latin America and the Caribbean reached a record level of about $50 billion in 1997, despite the contagion effect of the Asian financial crisis on a number of countries in the region. For the first time in several years, Brazil was the favourite destination, receiving some 25 per cent of the total, followed by Mexico (20 per cent) and Argentina (10 per cent). Major privatizations in the infrastructure, financial services and energy sectors in a number of countries have been a major impetus. An attractive business environment continued to underpin a significant expansion of FDI in Costa Rica in 1997 (over $500 million), with almost 40 per cent of total investment in the high-technology sector. This favourable trend in FDI in the region is expected to continue in 1998, as the privatization momentum is maintained and investment grows in the mining, oil and telecommunications sectors.

Gross FDI increased in Africa in 1997 to about $4.5 billion, continuing a trend that had started in the early 1990s. Major recipients included Egypt and Morocco, with total FDI in Morocco doubling to $1.2 billion. FDI has responded to opportunities that have been created by expanding privatization programmes and reformed investment regimes, particularly for the mining sector. FDI flows to South Africa also rose in 1997, although privatization of the telecommunication company can account for all of the increase over 1996 and the amount of "greenfield" foreign investments has been limited.

The concentration of FDI in Africa geographically and by sector has remained high. Seven countries (Angola, Egypt, Ghana, Morocco, Nigeria, South Africa and Tunisia) accounted for about 70 per cent of the FDI inflows in 1996 and 1997. FDI in energy and mining continued to be important, but foreign investment in manufacturing (electronics and automobiles) and tourism has increased in recent years in a number of African countries.

Multilateral financial cooperation

The medium-term trend of weakening official financial flows to developing countries in the 1990s has been interrupted on two occasions (see table A.25). One was the international response to the Mexican currency crisis that began at the end of 1994 and

the other was the response to the Asian currency crisis that began in 1997. With an essentially unchanged annual supply of official grants since 1993 and slowly rising interest payments on outstanding debt to official creditors – although the payments peaked in 1995, as there has been an easing of international market interest rates charged on much of that debt – the annual changes in net lending have been the main determinants of the changes in official net transfers. Some of this net lending takes the form of bilateral official development assistance and some is in the form of export credits, but a large part consists of multilateral flows that are subject to sharp annual changes, especially those of IMF.

IMF's mandate entails responding to balance-of-payments emergencies and so its lending flows are expected to be the most volatile of those of the multilateral financial institutions. In 1997, IMF committed $38 billion of its own resources (and mobilized considerably more from bilateral and other multilateral sources) in 14 arrangements for developing countries, compared with $5 billion for 20 countries in 1996 (see table A.27).[26] Ninety per cent of the IMF funds arranged in 1997 were for three countries: Indonesia ($10 billion), the Republic of Korea ($21 billion) and Thailand ($4 billion). In addition, IMF extended a $1 billion loan to the Philippines in July, as the first arrangement under its Emergency Financing Mechanism, which had been set up after the Mexican crisis in order to be able to commit funds quickly to countries that were following sound policies and needed additional financial support on an emergency basis.

Mainly as a result of these arrangements, net disbursements of IMF resources became positive in 1997, as had been the case in 1995 during the Mexican crisis. In several other years in the 1990s, however, member countries repaid loans to the Fund on a net basis. Indeed, despite new arrangements for 10 countries under its concessional lending programme, the Enhanced Structural Adjustment Facility (ESAF), in 1997 IMF began to receive net repayments from the group of low-income recipients of this and previous concessional lending (see table A.27).

The large total lending commitments by the Fund in 1997 raised questions about its financial capacity to respond to additional crises. The answer, entailing adoption of a policy proposal that had been in preparation for some time, was to enlarge the Fund's resources through a 45 per cent increase in quotas, which determine both drawing rights (borrowing limits) and voting rights in IMF.[27] The increase will add about $89 billion to the lending capacity of IMF and will take effect when ratified by 85 per cent of the voting membership. However, the timing of implementation has been rendered uncertain by the controversy in the United States Congress surrounding approval of the United States quota increase. As the United States holds 18 per cent of Fund voting rights, a negative decision on the quota increase by the Congress effectively vetoes the agreement to increase IMF quotas.

The Fund also devised a new mechanism to speed its resources to member countries in the midst of a balance-of-payments crisis. This time, IMF added – in contrast to the Emergency Financing Mechanism, which is a decision-making mechanism allowing quick deployment of regular Fund resources – a new facility, called the Supplemental Reserve

[26] IMF also committed $2 billion in seven arrangements for transition economies in 1997, compared with $13 billion in 12 arrangements in 1996 (see table A.28). The bulk of the funds arranged in 1996 were for the Russian Federation in a multi-year adjustment programme.

[27] In a related manner, IMF also approved a one-time increase in special drawing rights (SDRs). This is a form of Fund-created liquidity that was originally intended to become the main international reserve asset, but that has instead come to play only a minor role in supplementing the reserve assets of IMF member countries. The Fund agreement provided for creation of 21.4 billion SDRs (about $29 billion) for allocation to countries that had not received earlier allocations because they joined the Fund after the period of SDR allocations had ended (see *IMF Survey*, vol. 26, No. 18 (6 October 1997)).

Facility (SRF). The Facility is intended to supplement the resources under a regular standby or extended arrangement and to be deployed when there is a large need for short-term financing arising from a sudden loss of market confidence. Financing under the SRF can be in two or more tranches, to be decided at the time an SRF drawing is agreed, but the loans will be of shorter duration than regular standby arrangements (repayment in one to one and a half years after the date of each disbursement, instead of three to five years, although the Fund may extend the repayment period by up to a year). Also, SRF loans will be more expensive (3 to 5 percentage points above the usual IMF rate of charge on loans, which averaged about 4.7 per cent in 1997).[28] The first beneficiary of the SRF was the Republic of Korea in December 1997.

IMF aside, the bulk of the multilateral programmes of economic cooperation are not emergency response mechanisms, although some important ones are, such as activities of the World Food Programme (WFP) and the United Nations Children's Fund (UNICEF). Rather, they are mainly mechanisms for development cooperation – as well as for assistance to the economic transition process – and should thus be expected to mainly respond to long-run needs. They are nevertheless not immune to crisis situations.

In this regard, the Asian currency crisis has affected multilateral lending programmes in two ways. On the one hand, the lending commitments of the International Finance Corporation (IFC), the private sector lending and investment arm of the World Bank, dropped 25 per cent in 1997, mainly because several investment projects in the Asian crisis countries could not go forward as planned. On the other hand, significant and unanticipated lending programmes were arranged for crisis countries. For example, lending from ordinary (non-concessional) resources of the Asian Development Bank doubled to $8 billion in 1997, mainly owing to a $4 billion loan – the largest loan in the Bank's history – to the Republic of Korea. In addition, in late December 1997, the World Bank agreed to lend $3 billion to the Republic of Korea for economic reconstruction, focusing on the financial sector. This was particularly noteworthy since the Republic of Korea had graduated from eligibility for World Bank loans in 1994.[29]

Overall, multilateral resource commitments, excluding those of IMF, grew about 5 per cent and reached almost $51 billion in 1997 (see table A.31). All of the growth, however, was accounted for by non-concessional lending programmes. Expenditure by the operational programmes of the United Nations dropped for the second year in a row and the lending commitments of the International Development Association (IDA), the World Bank's concessional lending affiliate, fell below its 1995 level. The decline in IDA commitments, like the fall in non-concessional loans (identified as loans of the International Bank for Reconstruction and Development (IBRD) in table A.31), reflected implementation adjustments to the Bank's new policies of greater selectivity and delays associated with implementing a new, more decentralized operational strategy.[30]

Concessional programmes of the African Development Bank, however, rose from less than $300 million to over $1 billion, as the crisis in that institution eased. After a two-and-a-half-year delay caused by crisis and adjustment in Bank management, donor members of the Bank agreed in May 1996 to replenish the African Development Fund, the Bank's

[28] See "IMF approves supplemental reserve facility", *IMF Survey*, vol. 27, No. 1 (12 January 1998), p. 7.

[29] In view of this special situation, the Republic of Korea is being charged a higher-than-normal interest rate and its loan has to be repaid over a shortened period of 10 years (see World Bank news release, No. 98/1597/EAP).

[30] See World Bank, *Annual Report*, 1997 (Washington, D.C., 1997), "Overview of World Bank activities in fiscal 1997", and section one: "The Executive Board"; and section four: "Institutional renewal, development effectiveness, operations evaluation, and commitments and guarantees".

concessional window, with $2.6 billion for the period 1997-1999. The replenishment was a vote of confidence in reform efforts at the Bank, although it was short $400 million of the Bank management's initial request and $1 billion is from recycled funds, loan cancellations and arrears on earlier pledges, rather than new money.

In addition, non-concessional lending by the African Development Bank, which had declined sharply from 1992 to 1996, began to recover in 1997. To prepare the way for continued increases in such lending, the Board of Governors of the Bank was to consider in 1997 an enlargement of the Bank's general capital and future funding commitments. One sensitive point at issue was how much to raise the share of non-African countries in the equity and thus the decision-making of the Bank in exchange for greater non-African financial inputs (the non-African share has been 33.3 per cent). A large capital increase was not expected, however, as most African member countries eligible to draw only on the Bank's concessional loans and grants, which are funded separately, as noted above. A significant capital increase would nonetheless help to upgrade the Bank's credit rating, which fell in 1995.

Other multilateral banks have also had funding issues to contend with in 1997 and 1998, some of which were successfully concluded and some not. For example, agreement was reached in April 1998 to double the capital base of the European Bank for Reconstruction and Development (EBRD) to $22 billion. EBRD is a unique institution as more than three quarters of its lending is to the private sector in transition economies.

Similarly, deliberations were recently concluded for a general capital increase of the Multilateral Investment Guarantee Agency (MIGA), an arm of the World Bank that insures foreign direct investors against political and related risks in developing and transition economies. MIGA's capital is to be increased by $850 million (of which $150 million is to be paid in) and the World Bank is to transfer $150 million to MIGA in the form of a grant. This will both address a short-term financial constraint and provide MIGA with a sustainable capital structure for the medium term.

The concessional arm of the Asian Development Bank, the Asian Development Fund, was replenished in January 1997, but resources provided fell short of the target by $1.7 billion. The Bank planned to use transfers from its own net income to augment the replenishment and maintain concessional lending levels. This practice, however, has had to be discontinued, as the heavy demand for the ordinary resources of the Bank meant that it would have to build up its own reserve cushion. In addition, Japan's contribution to the Fund, accounting for more than one third of the total, has been reduced in dollar terms, owing to the weakness of the yen, in which its commitment is denominated.

In addition, while IMF's ESAF is not yet constrained in its lending capacity, its full financing for future lending programmes is not assured, and thus the Interim Committee of the Board of Governors of IMF "urged all members to move quickly to complete the financing" of this facility and of the HIPC initiative (see below). This is particularly germane in the light of the recent external evaluation of ESAF that "reaffirmed the view that ESAF is a valuable instrument to assist low-income countries".[31]

Official relief for heavily indebted poor countries

Arranging adequate funding is also one of the difficult issues that the World Bank and IMF have to contend with in implementing the special debt-relief programmes under

[31] See communiqué of the Interim Committee of the Board of Governors of IMF, Washington, D.C., 16 April 1998, para. 6.

their joint initiative for the heavily indebted poor countries (HIPCs). The innovation in the HIPC initiative was to bring eligible countries to a sustainable debt position as an exit strategy, regardless of the extent of relief required. This would also free HIPC countries from what had been long sequences of debt rescheduling and refinancing arrangements whose end could not be seen regardless of how sound the policies adopted by the debtor countries were, nor how long they were maintained.

In order to make the net debt reduction sufficiently large, however, the HIPC initiative required unusually deep reductions in the debt servicing owed to bilateral official creditors, which some creditor countries have resisted, and it introduced special processes for reducing the servicing of multilateral debt. The latter entailed the creation of special funds at IMF (the ESAF/HIPC Trust) and the World Bank (the HIPC Trust Fund), both of which have received transfers from the parent institutions and bilateral contributions, and from which grants and highly concessional loans are made to cover debt-servicing obligations.

The HIPC initiative requires potentially eligible low-income and heavily indebted countries to develop a "track record" of sound policy management, under adjustment programmes that are supported by the Fund and the Bank. HIPC debt relief is thus viewed as the end point of a process and an incentive for maintaining sound policies during the process, as well as an informal assurance to the creditors that the resources provided through debt relief will not be squandered. Before the end of the process, which is called the completion point, when the full debt relief is accorded, the HIPC country receives substantial financing and debt relief. The track record is generally expected to require six years to complete, but the commitment of the international community to the final arrangement is signalled roughly halfway through the period when the Boards of the Fund and the Bank approve the content of the final relief package. That agreement is reached at what is called the "decision point".

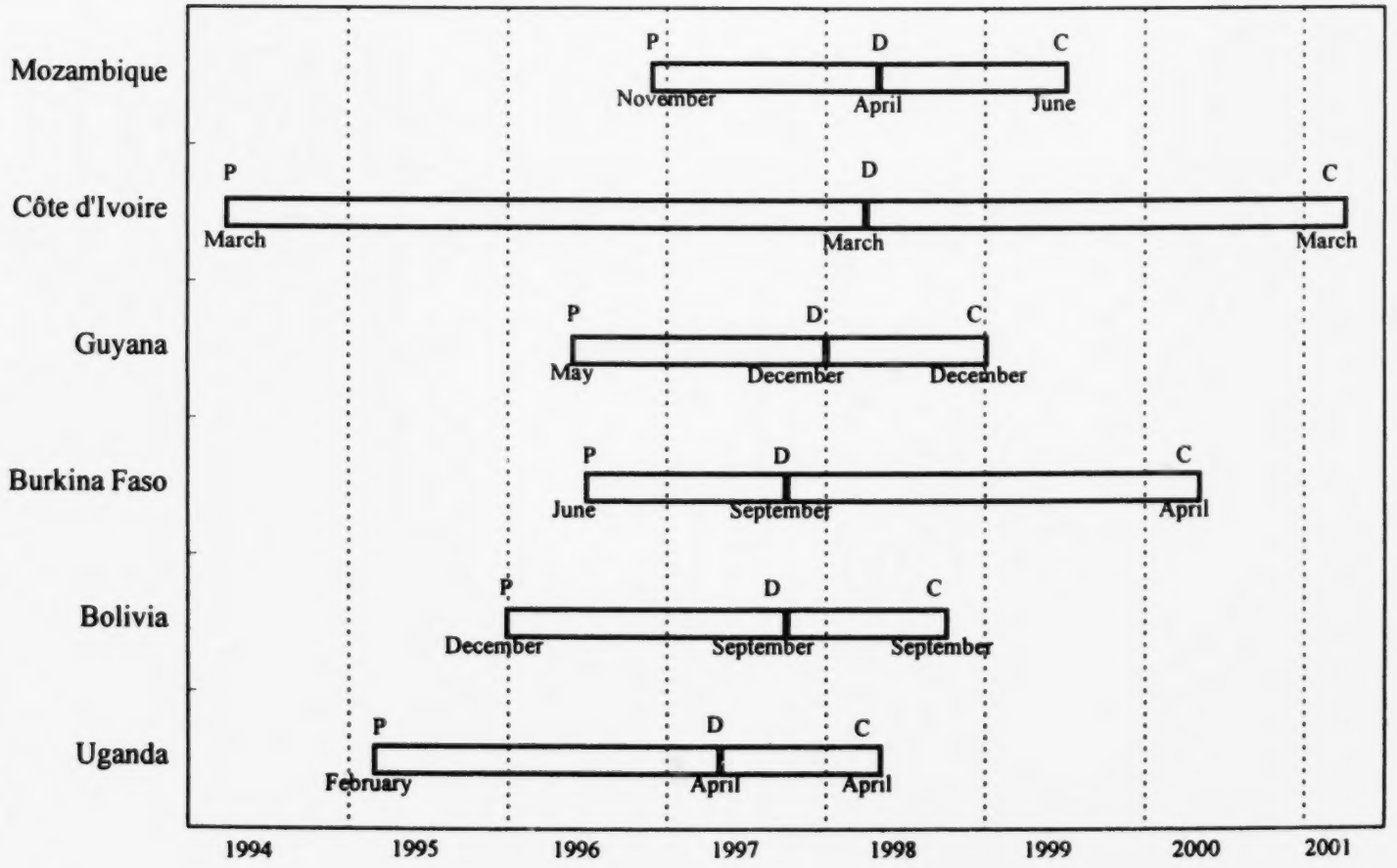
Since the HIPC programme was introduced in September 1996, only one country has reached the completion point: Uganda in April 1998. Six countries have reached the decision point: Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mozambique and Uganda (see figure III.5).[32] Each country is generally viewed as having started its track-record period at the point at which it received a particular (and substantial) degree of debt relief (usually "Naples terms") from the Paris Club, which is the forum of official creditor agencies for restructuring bilateral official debt. Of the six countries, only Bolivia and Guyana, in addition to Uganda, are expected to complete their HIPC process by the end of 1998.[33]

Additional countries are in the HIPC pipeline and others will be considered in due course. Both debtors and creditors, particularly the Bank and the Fund, are committed to implementing the HIPC programme as quickly and comprehensively as possible. However, the process is highly complex and requires unprecedented cooperation and coordination

[32] One additional country, Benin, was judged in July 1997 not to need the extraordinary relief of a HIPC programme.

[33] It may be noted in figure III.5 that the track-record period is less than six years in some cases and longer in one case. The longer period results from a break in the period under an active IMF programme, while the shorter periods reflect "credit" given for earlier, continuous years of adjustment. Moreover, in the case of Mozambique, the fact that creditors had difficulty in reaching agreement on the final debt-relief package delayed the "decision point" (mid-1997, as originally intended) until April 1998, in the light of which the period to the "completion point" was shortened so as not to penalize Mozambique for the delay.

Figure III.5
Implementation of the Heavily Indebted Poor Countries Debt Initiative



Source: **World Bank (data as of April 1998).**

Note: **P: Paris Club rescheduling; D: decision point; C: completion point.**

of Governments and multilateral institutions and therefore seems to proceed quite slowly. With this in view, the British Chancellor of the Exchequer launched the "Mauritius Mandate" at the Commonwealth Finance Ministers' meeting of 15-17 September 1997 in Mauritius. That initiative seeks to ensure that all eligible poor countries at least embark on the process of securing a "sustainable exit" from their debt problems and that the HIPC process in particular is accelerated. This requires, *inter alia*, that funding arrangements for HIPC relief be more assured.[34] This, in turn, calls for national Governments and other creditors to be more forthcoming in the resources they are prepared to make available.

International aspects of the introduction of the euro

On 1 January 1999, the monetary union stage of Economic and Monetary Union (EMU) begins in Europe. While notes and coins in national currency will continue to circulate over three more years, the euro will start to be used in transactions by banks and enterprises. It will be overseen by the European System of Central Banks (ESCB), comprising the European Central Bank (ECB), based in Frankfurt, Germany, and the national central banks of the 11 initial members of the monetary union (EUR11) – Austria, Belgium, Finland, France, Germany, Luxembourg, Ireland, Italy, the Netherlands, Portugal and Spain – which will become components of ESCB.[35] The rates for conversion of the national currencies into the new euros will have been irrevocably fixed by this point. The euro will be the single currency, and the national currencies taking part in the monetary union will become merely different denominations of the euro. After July 2002, the currencies of the first 11 entrants will no longer be legal tender.

This degree of monetary innovation in a trading bloc as large as EU may have considerable effects on international financial relationships, including shifts in the composition of the foreign reserve assets of the world's central banks, portfolio shifts on the part of the private sector, changes in the currency invoicing of world trade flows, and macroeconomic effects emanating from monetary, fiscal and exchange-rate policies adopted by EU.

The new European economy

EU is about to undergo a fundamental change in economic relationships. EUR11 – which had a population of 290 million and a GDP roughly similar to that of the United States, accounting for almost a fifth of world output and world trade (excluding intra-EU trade)[36] – will become a very large single currency area. Its dependence on external trade is similar to that of the United States, with merchandise imports from non-EU countries accounting for about 10 per cent of GDP. EUR11 holds 16 per cent of world foreign exchange reserves, while the currencies that will disappear constitute 20 per cent of the reserves presently held by the world's central banks (including the reserves of the 11 members of the bloc itself).

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[34] See Commonwealth Secretariat, *International Capital Markets*, vol. 17, No. 4 (December 1997), pp. 10-11.

[35] Denmark, Sweden and the United Kingdom of Great Britain and Northern Ireland had the option of joining in 1999, but declined to do so. Greece is expected to meet the criteria for entry in a few years, having made considerable progress towards economic convergence with the countries that will be the initial members of the monetary union.

[36] European Commission, *European Economy* (Luxembourg), Supplement A, Nos. 3/4 (March/April 1998), p. 12.

Table III.2.
Economic convergence in the European Union, 1997 versus 1988

	Inflation[a] (annual percentage change)		*Budget position (percentage of GDP)*		*Nominal long-term interest rates (annual percentage rate)*		*Unemployment (percentage of labour force)*	
	1988	*1997*	*1988*	*1997*	*1988*	*1997*	*1988*	*1997*
EUR11								
Austria	1.6	1.9	-3.0	-2.5	6.7	5.7	3.6	4.5
Belgium	1.2	1.7	-6.8	-2.1	7.9	5.8	8.9	9.5
Finland	4.6	1.3	4.1	-0.9	10.6	4.9	4.4	14.0
France	2.6	1.3	-1.7	-3.0	9.0	5.6	9.8	12.6
Germany	1.4	2.1	-2.2	-2.7	6.1	5.1	6.2	9.7
Ireland	4.0	1.4	-4.5	0.9	9.4	6.5	16.1	10.2
Italy	5.9	2.2	-10.7	-2.7	12.1	6.6	10.0	12.2
Luxembourg	2.8	1.6	..	-1.7	7.1	5.4	2.0	3.7
Netherlands	0.5	2.1	-4.6	-1.4	6.3	5.8	7.5	5.4
Portugal	11.7	2.2	-3.6	-2.5	13.9	5.5	5.5	6.4
Spain	5.0	2.1	-3.0	-2.6	11.7	5.9	19.5	20.9
Other member countries								
Denmark	1.4	2.1	0.6	0.7	10.6	6.3	6.1	6.2
Greece	14.2	6.0	-11.5	-4.0	16.6	10.8	6.8	9.5
Sweden	6.1	1.8	3.5	-0.8	11.4	6.6	1.9	10.2
United Kingdom	5.0	2.4	0.7	-1.9	9.3	7.1	8.7	7.2
EU average	3.9	2.1	-3.1	-2.4	9.1	5.9	9.1	10.7

Sources:
Statistical Commission of the European Countries (Eurostat), *EC Economic Data Pocket Book*, No. 2, 1998; Eurostat, *Money and Finance*, various issues; and European Commission, *Convergence Report* (Brussels, 1998). All statistics are according to Eurostat definitions.

[a] Price deflator of private consumption.

Even before introduction of the single currency, trade and capital restrictions within EU were progressively eliminated and the harmonization process has greatly reduced macroeconomic differences among the countries. Indeed, there has been a remarkable convergence in macroeconomic policy and performance since the move towards the Single European Market began in July 1987. Among EUR11, inflation in 1988 ranged from 0.5 to 11.5 per cent; in 1997, the range was from 1.3 to 2.2 per cent (see table III.2). The range of long-term interest rates in 1988 was from 6.7 per cent to nearly 14 per cent; in 1997, the range was from 5.1 per cent to 6.6 per cent. Budget positions have also converged. Most dramatically, Italy's budget deficit was cut from nearly 11 per cent of GDP to less than 3 per cent.

The synergies of this large and increasingly harmonized market are expected to take a dramatic leap forward with the introduction of the single currency. Investment is expected to be boosted, including incoming FDI, as businesses begin to sell to a potentially vast pool

of buyers using a single, fully convertible and widely traded currency. At the same time, EU is adopting policies to improve the functioning of markets, particularly labour markets, that are to make EU more investor-friendly, albeit, many argue, at the expense of weakened social protection for labour. The anticipated return for the higher risk of unemployment is to be faster growth of productivity, wages and average employment levels.

Monetary union is expected to revolutionize EU financial markets. Beginning in 1999, Governments of EUR11 will start issuing their debt in euros and will begin to re-denominate much of their existing debt stocks. By 2002, all their debt will be re-denominated, as will other securities. The citizens of Europe – and of other countries – will find a wide range of instruments issued by different countries and companies, all denominated in a single currency and many traded on various national financial markets, which will increasingly merge into an integrated European market.

Moreover, macroeconomic policy guidelines have been constructed with a view to ensuring that the monetary union remains an area of low inflation and fiscal conservatism. The Maastricht Treaty on European Union stipulated that ESCB was to be independent. Neither ECB, participating national central banks, nor any member of their decision-making bodies is allowed to seek or take instructions from community institutions or bodies, from any Government of a member State or from any other body (article 107 of the Maastricht Treaty). While ESCB is independent, its primary objective is clearly specified: "to maintain price stability" yet "*without prejudice to the objective*" (emphasis added), to contribute "to the achievement of the (other) objectives of the Union as laid down in article 2" (of the Treaty).

Governments in EU remain sovereign, but fiscal policy is constrained by the EU-wide Stability and Growth Pact, which was agreed at the European Council meeting in Dublin in December 1996. That the Pact requires EU member countries to keep general government budget deficits below 3 per cent of GDP under most circumstances effectively necessitates near-fiscal balance or a surplus over the medium term so as to avoid exceeding the 3 per cent limit during difficult periods. As noted in chapter II, this factor, coupled with the single-focus monetary policy, reduces the ability of individual EUR11 Governments to respond to adverse economic shocks; EU collectively will also have little institutional means to respond. Here lies an important source of vulnerability in the new European economy and a part of the unfinished business in the development of EU.

A new international money

On 1 January 1999, when the economies of EUR11 introduce their new currency, the world economy will also have a new currency to use in international transactions. It may use the euro for the invoicing of international trade flows and as an investment and reserve currency.

The euro can also serve as a new currency peg. Indeed, a number of developing and transition economies have tied their exchange rates to the national currency of one or another EU member State. Fourteen francophone African countries use the Communauté financière africaine (CFA) franc, which is presently pegged to the French franc (see box III.2). The economies of Central and Eastern Europe, particularly the 10 countries that have applied for EU membership and that have seen very major shifts in the direction of their trade flows towards EU, are tied tightly to the deutsche mark or a basket of European currencies. Bulgaria and Estonia presently operate currency boards based on the deutsche mark. All will need to adjust their policies when 1999 begins.

Box III.2.
The CFA franc zone in 1999: a new peg but not a new regime

Since 1948, several African countries have pegged their common currency, the Communauté financière africaine (CFA) franc, to the French franc. The latter currency will begin to disappear and be replaced by the euro, as France and 10 other member States of the European Union (EU) introduce on 1 January 1999 the monetary integration phase of their Economic and Monetary Union (EMU). The African countries and France have had to decide how to reset the peg.

The CFA franc is, first of all, more than the currency of 14 separate African countries; it is a central part of two regional integration schemes. One is the Union économique et monétaire Ouest-africaine (UEMOA), linking eight countries: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau (which joined the franc zone in 1997), Mali, the Niger, Senegal and Togo. The other is the Communauté économique et monétaire d'Afrique Centrale (CEMAC), comprising six countries: Cameroon, the Central African Republic, Chad, the Congo, Equatorial Guinea (which entered the zone in 1985) and Gabon.[a]

Although trade within each economic and monetary grouping has been rather small, it has increased over time, in particular since the (one and only) devaluation of the CFA franc in January 1994.[b] Moreover, the two groups have been taking policy steps to enhance integration within their regions. Thus, institutional development has been deepening in UEMOA, as evidenced by the creation of an executive commission, a court of justice and fiscal surveillance. In CEMAC,[c] tax and tariff harmonization is progressing. In addition, customs duties were cut in CEMAC in July 1997 and abolished on 1 January 1998. In UEMOA, they are to be eliminated in the year 2000.

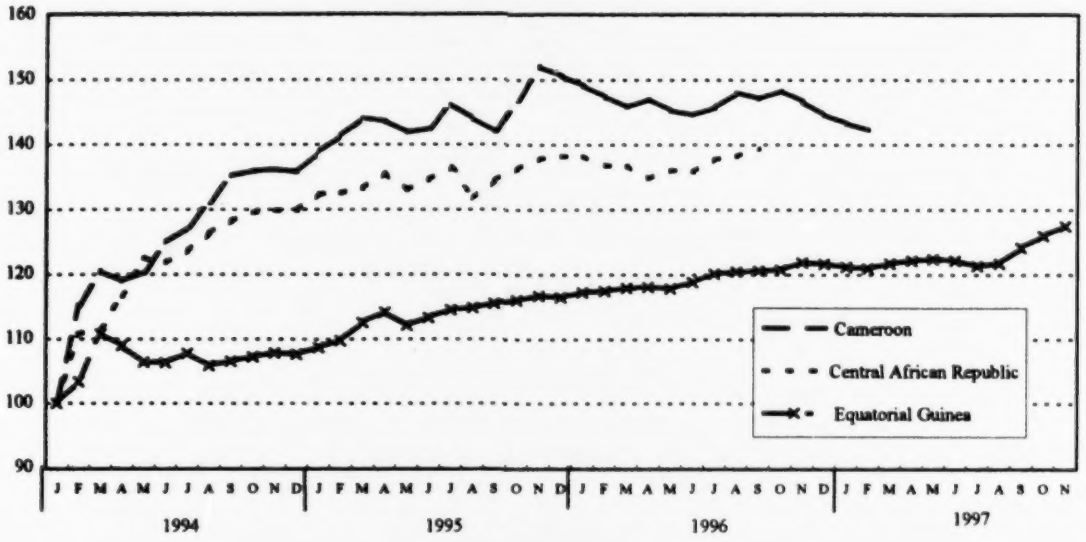
The peg of the CFA franc has been maintained by the central banks of each region, in an arrangement with the French Treasury. The Government of France guarantees the convertibility of the CFA franc into French francs at the pegged rate through an operations account at the Treasury, which pools the foreign exchange reserves of the member countries, and through which France can extend overdraft credit to the CFA central banks. Technically, there is no constraint on the continuation of this arrangement past 1 January 1999, other than the change of the peg.[d]

The Governments of the countries of the CFA franc zone and France have indicated that they intend to keep the exchange rate vis-à-vis France unchanged when the peg is shifted to the euro. The parity of the CFA franc to the euro thus depends on the conversion rate of the French franc to the euro, which would be fixed in perpetuity on 1 January 1999. However, will this be the most desirable exchange rate for the CFA franc zone?

Before the CFA franc was devalued in January 1994, the currency had become substantially overvalued and the exchange rate could no longer be sustained by the French Treasury.[e] Since the devaluation, the exchange rate has not been changed. However, because the value of the French franc has changed against the currencies of other trading partners of the CFA franc zone and because of domestic price inflation, the inflation-corrected average exchange rate of each of the countries in the CFA franc zone has appreciated. As calculated by the International Monetary Fund (IMF), the "real effective exchange rates" (REERs) of the CFA franc zone countries had risen from January 1994 until the end of 1995 by between 17 and 51 per cent. The REERs then remained roughly

Real effective exchange rates (REERs) of selected African countries, 1994-1997

(January 1994 = 100)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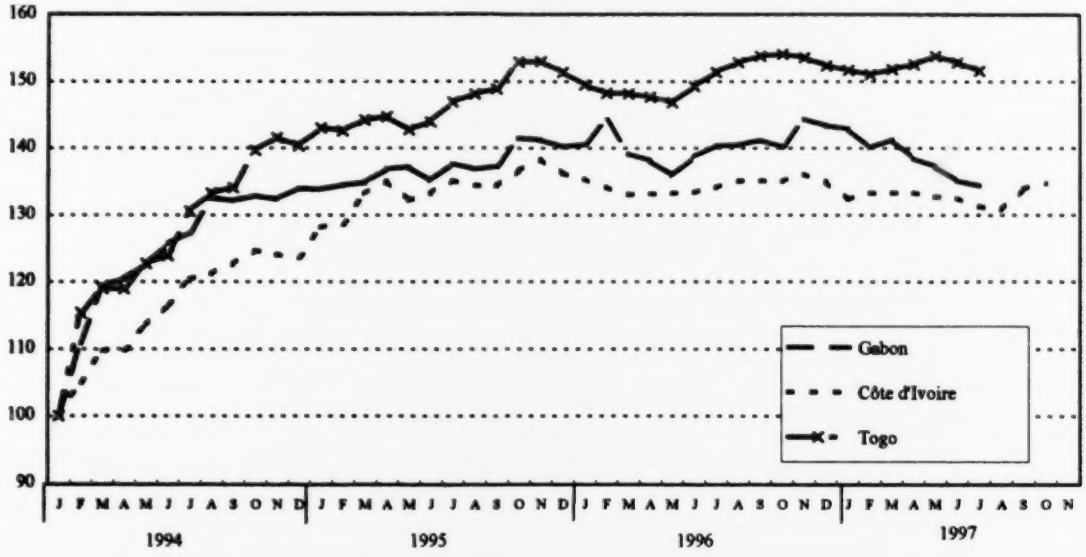

Source: IMF, *International Financial Statistics,* April 1998.

constant until the third quarter of 1997. Data are available for only a few countries beyond that point, but for them the REERs started to rise again (see accompanying figure). Total appreciation of the REER in the franc zone countries from January 1994 until the end of 1997 varied from 28 per cent in Equatorial Guinea to 52 per cent in Togo (as of July 1997). A case might thus be made for taking advantage of the need to change the peg in January 1999 and devalue. Indeed, there are indications that something of this sort was feared in some of the franc zone countries in the spring of 1998.

One could go further, however, and ask whether the resetting of the peg might be an opportunity to further redefine it in order to better reflect the trade of the franc zone countries. These countries are for the most part exporters of commodities and are largely price takers in global markets that operate in dollars. Their trade is also almost evenly divided between countries that are likely to be linked to the euro and those that will not be so linked. For example, in 1995-1997, France absorbed 12 per cent of the exports of the franc zone and the rest of EU about 30 per cent; intra-zonal trade accounted for less than 7 per cent of the total.[f] An appreciation of the euro against the dollar would reduce the export earnings (and export incentives) of CFA franc zone countries, and put an extra burden on import-competing sectors (for example, food and some local manufacturing). A depreciation of the euro would have the opposite effect. In either case, the change in the exchange value of the euro, and hence of the CFA franc, would have nothing to do with the balance-of-payments needs of the CFA franc countries.

One solution might be to peg the CFA franc to a basket of currencies. This, however, would be difficult to engineer under the present arrangements. The peg of the CFA franc to the French franc has been guaranteed through commitments involving the national currency of France. While the commitments entailed a possible budgetary drain on France, they did not encumber French foreign currency reserves. This will still be the case after the peg is shifted to the euro. However, a multi-currency peg for the CFA franc would all but have to be defended by a mixed portfolio of foreign currency reserves, which would require a radical reform in the exchange-rate and reserves management of the regional central banks and reduce their ability to rely on French support.

Not surprisingly, announced policy is to neither alter the exchange-rate regime nor devalue the CFA franc. The priority is, instead, to maintain the stability in the external environment, at least in that part of it accounted for by the considerable economic and financial relations with the euro area. The risk in this strategy is the same as in the peg to the French franc: with higher inflation in the CFA franc countries than in EU and with the possible strengthening of the euro against the dollar, there will be a loss of international competitiveness. In addition, if there is a high degree of volatility in the euro/dollar exchange rate, which some fear. It would give variously changing signals to enterprises in the CFA franc zone. However, in the view of others, these risks are overrated and are not sufficient reason to abandon a set of relationships and support mechanisms that are well known and have served over a long period of time.

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[f] In fact, each grouping has a separate currency, although both currencies are known as the CFA franc. In UEMOA, the currency is issued by the Banque centrale des États de l'Afrique de l'Ouest (BCEAO), and CFA stands for "Communauté financière de l'Afrique". In CEMAC, the currency is issued by the Banque des États de l'Afrique centrale (BEAC) and CFA stands for "Coopération financière africaine". In addition, the Comoros pegs the Comorian franc to the French franc.

[b] See International Labour Organization, "Devaluation of the CFA franc four years on: economic integration and employment on the agenda", *International Labour Review*, vol. 136, No. 3 (autumn 1997), pp. 401-417.

[c] CEMAC replaced the Union douanière et économique d l'Afrique centrale (UDEAC) in February 1998.

[d] Had the arrangement operated through the French central bank, continuation would have been more complicated, as may of the functions of the Banque de France will be transferred to the new European Central Bank (see Michael T. Hadjimichael and Michel Galy, *The CFA Franc Zone and the EMU*, IMF Working Paper, No. WP/97/156 (Washington, D.C., November 1997); and John Berrigan and Hervé Carré, "Exchange arrangements between the EU and countries in Eastern Europe, the Mediterranean and the CFA Zone", in *EMU and the International Monetary System*, Paul R. Masson, Thomas Krueger and Bart G Turtelboom, eds. (Washington, D.C., IMF, 1997), pp. 122-135).

[e] See *World Economic and Social Survey, 1994* (United Nations publication, Sales No. E.94.II.C.1 and corrigendum), box II.3.

[f] Based on data of IMF, *Direction of Trade Statistics*, April 1998.

One of the currencies due to disappear, the deutsche mark, is, next to the dollar, the most widely used currency both for denominating private sector securities and as a reserve asset for central banks.[37] The euro will presumably take over this role from the deutsche mark and the other major EU national currencies and compete with non-European currencies, particularly the dollar, performing similar functions.

Unit of account

One aspect of being an international money entails serving as a unit of account. Normally, internationally active enterprises prefer to invoice their transactions in their own currencies, thus avoiding conversion costs and the possibility of losses from exchange-rate changes or the costs of hedging against such losses. Thus, in 1992, 92 per cent of United States exports were invoiced in dollars and 77 per cent of German exports were in deutsche marks (although only 40 per cent of Japanese exports were in yen).[38] With the arrival of monetary union, EU firms are likely to invoice increasingly in euros.

Globally, almost half of total export invoicing is in dollars, while one third is in one of the five main EU currencies. The share of the euro will exceed that of its predecessor currencies, since all the trade among EUR11 will be invoiced in euros and its external trade will likely be increasingly invoiced in euros as well. Certainly, firms in neighbouring countries, particularly those in Central and Eastern Europe for which EU has become the dominant trading partner, may be expected to adopt the euro as a unit of account for trade with EU as well as among themselves, as may multinational enterprises that trade mainly with Europe.

Means of exchange

The role of the euro as an international means of payment will be reflected in its turnover in foreign exchange markets. The average daily turnover in the world's foreign

[37] See Deutsche Bundesbank, "The role of the deutsche mark as an international investment and reserve currency", *Monthly Report*, April 1997, pp. 17-30.

[38] Richard Portes and Hélène Ray, "The emergence of the euro as an international currency", *Economic Policy: A European Forum*, No. 26 (April 1998), p. 316.

exchange markets in April 1995 was estimated to be $1,137 billion.[39] This total may be divided into the three main foreign exchange instruments: about $494 billion for spot transactions, $97 billion for simple forward foreign exchange transactions and $545 billion consisting of foreign exchange swaps. The dollar dominates the global market for all three classes of instruments, accounting for over 35 per cent of all spot transactions, just under 40 per cent of forward deals, and nearly 50 per cent of swaps. For each of these markets, the share accounted for by all the currencies in the European Monetary System (EMS) and its own European currency unit (ECU) was 42 per cent, 33 per cent and 28 per cent, respectively. The yen's share of each type of transaction was considerably lower: 11 per cent, 14.5 per cent and 12.5 per cent, respectively. The share of all other currencies was also small: 11 per cent, 13 per cent and 12 per cent, respectively. With the euro replacing the national EU currencies, dealings in foreign exchange markets are likely to become tripolar, dominated by the dollar, the euro and, to a much smaller extent, the yen.

Store of value: the euro as an official reserve asset

In 1990, about half of the world's foreign exchange reserves were held in dollars. The dollar's share has since risen to just under 60 per cent of the total (as of 1996), reflecting the surging growth of trans-Pacific trade, with about one quarter of official reserves left to be held in EU currencies and the ECU (about 6 per cent of reserves are held in yen).[40] As the reserves denominated in EU currencies are mainly held in the form of government securities, they will automatically be converted into euros as EUR11 re-denominates its official debt in 1999.[41] The euro thus automatically enters into the reserves portfolio of non-EUR11 countries. In addition, non-EUR11 countries may decide to increase the share of their reserves in euro assets, as euro reserves will have greater liquidity than any of the predecessor national currencies, owing to the economic area for which the euro serves as the local currency.

Countries that peg their exchange rates to the euro will find it convenient to hold euros for intervention in foreign exchange markets in order to smooth out market volatility around the peg. This applies in particular to Denmark, Greece and Sweden, which are staying outside the monetary union and might participate in a successor to the EU's exchange rate mechanism (ERM II).[42] It also applies to the countries that have applied to join EU and that have pegged to the deutsche mark in recent years.

Whether the total reserve holdings of euros rise or fall after the initial conversion, the total holdings of dollars in foreign currency reserves are likely to fall, at least in the short run. This is mainly because ECB will need to maintain smaller reserves than the sum of the reserves that were needed by the central banks that issued the predecessor currencies before 1999. The exchange rate of the euro will fluctuate against all other international currencies – even if exchange-rate movements are sometimes dampened – whereas the 11 national central banks pledged themselves to defend a fixed set of currency pegs vis-à-vis each other.

[39] Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivatives Newest Activity 1995* (Basel, May 1996), table 1-A.

[40] IMF, *Annual Report 1997* (Washington, D.C., 1997), table I.2.

[41] The reserves of EUR11 itself will automatically shrink when the euro era begins, because the holdings by the 11 national central banks of securities and deposits in the currencies of other EUR11 countries will be converted from foreign into local currency (the euro) and thus no longer count as foreign reserves.

[42] The United Kingdom has stated that it will not enter the mechanism in the near future.

The national central banks will have to transfer initially 50 billion euros worth of foreign exchange to ECB and this will make up the initial foreign currency reserves of EUR11. Members will be subject to calls for further contributions, but holdings of foreign exchange under national central bank control will no longer themselves function as foreign currency reserves. Use of the foreign reserves remaining in the ESCB central banks will be subject to ECB approval to ensure that their use does not conflict with the exchange rate or monetary policies of the area; but these funds will not be needed for their traditional purpose of national exchange-rate management and are likely to be reduced over time.

The risk of the excess dollar holdings being liquidated rapidly seems slight, however, as this might cause a sharp fall in the value of the dollar and central banks would want neither to disrupt foreign exchange markets nor to sell their dollars into a falling market. The large dollar holdings do, though, call for cooperation between the United States Federal Reserve and ECB and the member central banks of ESCB in order to ensure an orderly transition.

Store of value: private demand for euro assets

It is expected, then, that the central bank portfolios of reserve currency assets will be re-balanced, but, in addition, that private portfolios will increasingly contain euro assets. As already noted, the euro is expected to revolutionize the financial markets of EUR11. The creation of the euro is occurring alongside major policy and market changes across European financial markets. Transparency is growing and regulatory practices are being harmonized, reducing market fragmentation. The range of products offered in EU financial markets is also growing, as financial centres such as Frankfurt, Paris, Milan and London compete with each other. For example, the number of maturities offered in government bond markets is being expanded to produce a more continuous range of maturities – and a smoother yield curve – from very short-term debt to long-term debt. In addition, there is a growing competition between security financing and traditional commercial-bank financing, and a substitution of the former for the latter.

The depth and liquidity of euro-denominated financial markets may thus be expected to increase further, as the euro removes the exchange-rate risk for investors from within the euro area. While exchange-rate risk will remain for those outside the euro area, the increased liquidity of euro-markets will greatly increase the attractiveness of euro-denominated financial instruments for both borrowers and lenders in the rest of the world.

This will be the case especially if the United Kingdom enters the monetary union. The United Kingdom financial market is particularly important because of its great size and liquidity. An international investor generally prefers to enter a market where a large number of buyers and sellers are operating, so that there is no shortage of potential participants to complete a transaction, and where transactions are typically of such magnitudes that any single purchase or sale the investor makes will not disrupt the market. London already satisfies those criteria for a wide range of financial instruments. Indeed, considerable trading of euro-denominated securities can be expected in London even with the United Kingdom outside the euro area.

With the changes under way in the internal organization of financial markets in the countries of the monetary union and parallel changes in London, global borrowers and lenders will be able to access an integrated financial market which will be the second biggest in the world after that of the United States. This euro-market may thus be expected to play a more important role in the disposition of global savings than is currently being played by the markets of individual EU member States.

The increased competition for savings, the potential efficiency gains from market integration and the wider product range of financial instruments are also expected to produce some lowering of transaction costs for non-EU issuers and buyers of debt instruments. Both developed- and developing-country issuers of international debt, whether public or private sector, stand to gain from having the choice of issuing debt denominated in the currency of an increasingly integrated and liquid market. These changes are already beginning to influence the borrowing strategies of developing countries, as witnessed by the recent growth in the volume of euro-fungible debt issues.[43]

Dollar-denominated instruments currently dominate the shorter end of the maturity structure in international issues, accounting for 60 per cent of money market instruments. Instruments denominated in EUR11 and in the other EU currencies (including ECU denominations) account for 16 per cent and 22 per cent, respectively, of the international market. The yen accounts for about 3 per cent of the market. However, in the international bond and note market, the dollar accounts only for approximately 40 per cent. The share denominated in ECU or EUR11 currencies accounts for a further 25 per cent which rises to 33 per cent in the case of EU-15. The share of the yen is 16 per cent.

All in all, the euro is thus expected to increase its share of global financial markets, primarily at the expense of the dollar. Estimates of the size of the possible shift vary considerably.[44] A rapid change would, other things being equal, produce a sharp fall in the value of the dollar vis-à-vis the euro. A more gradual re-balancing would be more benign and appears more likely, as noted above in the case of the disposition of excess EU holdings of dollar reserves. In the case of bonds, the main reason for a gradual change is that some time may be required before continental European bond markets deepen sufficiently to be attractive to large numbers of international investors.

When that does happen, European Governments will be able to share in the lower interest rates that the United States Government currently enjoys as a result of the international demand for United States Government bonds and notes. Another consequence of this portfolio shift from dollar to euro-denominated assets is that it would reduce the quantity – or the growth of the quantity – of dollars that are held outside the United States. Those dollar balances represent an interest-free loan to the United States, although the value of this seigniorage to the United States economy as a whole is small – about 0.1 per cent of United States GDP.[45] If the euro were increasingly held outside EU, this would represent a net gain to the Union, and a switch from external dollar balances to external euro balances would reduce the seigniorage enjoyed by the United States. As a share of the GDP of EUR11 and the United States, however, the amounts of the shifted seigniorage would be quite small.

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[43] See Bank for International Settlements, *International Banking and Financial Market Developments* (Basel, November 1997), p. 20.

[44] For instance, Bergsten reports a range of $100 billion-$300 billion as the likely shift in official reserves and a further $350 billion-$700 billion global shift in private portfolios containing bank deposits, bonds and notes. Thus, the total shift due to global portfolio re-balancing could be in the range of $500 billion to $1 trillion. Total official reserves excluding gold in March 1997 were $1,837 billion and Bergsten estimated that, excluding intra-EU holdings, global holdings of international financial assets, including bank deposits and bonds, were about $3.5 trillion (see C. Fred Bergsten, "The impact of the euro on exchange rates and international policy cooperation", in *EMU and the International Monetary System*, Paul R. Masson, Thomas Krueger and Bart G. Turtelboom, eds. (Washington, D.C., IMF, 1997), p. 30).

[45] Portes and Ray, loc. cit., p. 309. For a fuller discussion of seigniorage, see *World Economic and Social Survey, 1997: Trends and Policies in the World Economy* (United States publication, Sales No. E.97.II.C.1 and corrigenda).

Exchange-rate volatility?

While the euro will completely eliminate exchange-rate instability among EUR11 countries, implications for the stability of exchange rates between the euro and the currencies of the rest of the world are less clear. For example, instability might increase if the sharp fall in the share of "external trade" in the GDP of the monetary union influenced policy makers. As indicated earlier, the share of extra-EU imports in the GDP of EU will be of the same order of magnitude as the corresponding share for the United States, about 10 per cent. Because of the small trade share, policy makers in the United States have on occasion taken a "benign neglect" approach to exchange rates, which EUR11 authorities might thus also take from time to time.

In the case of the United States, benign neglect meant that monetary policy targeted domestic monetary conditions and the exchange rate adjusted to resolve inconsistencies between monetary and fiscal policy. However, it is easier to pursue a policy of benign neglect where there are few close substitutes for holding the country's assets. It becomes a less viable policy when expectations of exchange-rate changes may generate large capital flows into or out of assets in other currencies.

In EU, as noted above, monetary policy will seek price stability as its primary goal. The question is thus whether the independent Governing Council of ECB will take into account the exchange-rate implications of its monetary policy and seek stability between the euro and the other major currencies. ECB is not, however, the only decision maker in this realm. There are other official actors who are not independent of the EU Governments, namely, Ecofin, which is the Council of Finance Ministers of EU, and Euro-11. Whereas Ecofin is the prime forum for macroeconomic policy coordination within the Union, Euro-11 is the informal meeting of the 11 finance ministers of the countries participating in the monetary union.[46]

At this point it is not possible to say how relations between these various bodies will evolve. However, article 111 of the Maastricht Treaty foresees the possibility that the Council, after consulting with ECB in an endeavour to reach a consensus consistent with the objective of price stability, and after consulting the European Parliament, may conclude formal agreements on an exchange-rate system for the euro in relation to non-Community currencies. In the absence of such formal agreements, again after consulting ECB, or on a recommendation from ECB, it could formulate "general orientations for exchange-rate policy" in relation to other currencies.

An informal meeting of Ecofin ministers at Mondorf, Luxembourg, in September 1997 reached broad agreement on the divisions of responsibility: ECB would "ordinarily" be in charge of exchange-rate policy, while Ecofin ministers would become involved only if there were overriding political reasons or during financial crises. The prospect for volatility, then, seems to depend on how these principles are put into practice as ECB begins operations; but it also depends on whether there is a smooth transition to new arrangements for international consultation and coordination among the major currency countries.

[46] When discussing issues related to the operation of the monetary union, such as exchange-rate policy of the euro vis-à-vis the dollar, Ecofin will not include the finance ministers of the four non-participants, that is to say, it will sit as Euro-11.

International monetary coordination

EMU presents a number of institutional questions concerning the future governance of the international monetary system. The central consultative mechanism that operates today evolved out of the series of annual economic summit meetings of the seven major industrialized countries (the Group of Seven) that stretched back to the mid-1970s.[47] The Group of Seven macroeconomic process is a governmental one, managed by finance ministers, in which central banks also participate. The Group of Seven consists of three members of the coming monetary union (France, Germany and Italy), the United Kingdom, an EU member outside the euro area, and Canada, Japan and the United States. Representatives of the European Commission also participate and it can be expected that the President of ECB will have an important voice in the Group of Seven.

The creation of the euro will also raise several issues for IMF, including what role the euro should play in Fund operations and how the currency composition of the SDR, the IMF's unit of account, is redefined. The SDR is at present both a currency-based and a country-based basket, containing the currencies of the five members with the largest levels of exports of goods and services. It is currently composed of dollars, deutsche mark, yen, French francs and sterling. The introduction of the euro raises the question whether the weight to be assigned to the euro should be based on the non-euro area exports of the countries whose currencies will disappear, or the non-euro area exports of all EU members, or some other criterion.

The regular surveillance of the macroeconomic policies of EU members by IMF will also need some adjustment. It will no longer be relevant to include discussions on exchange-rate matters in the annual consultations with national authorities in EU, as the independent ECB will determine monetary policy – and it will do so not with a view to any one member's economic situation, but rather with a euro-area perspective. Surveillance of exchange rate policy would appear, though, to require consultation with the bodies that will have responsibility for monitoring economic policy, namely ECB, Ecofin, and Euro-11, the latter two being assisted by the Economic and Financial Committee.[48] It will remain an internal matter for EU to decide how euro-area members are to be represented in IMF Executive Board discussions of exchange-rate policy involving the euro.

Conclusion

On creation, the euro will become the second most important reserve currency. The introduction will introduce "a clear hierarchy of currencies" with a distinction between the three reserve currencies, the dollar, euro and yen, and all other currencies.[49] The three reserve currencies will float against each other, but a European policy of benign neglect appears unlikely in an increasingly integrated and liberalized world financial system where

[47] See C. Fred Bergsten and C. Randall Henning, *Global Economic Leadership and the Group of Seven* (Washington, D.C., Institute for International Economics, 1996).

[48] The Economic and Financial Committee replaces the EU monetary committee that prepares Ecofin meetings. It is made up of national treasury officials, central bankers and two members of the European Commission. It is, *inter alia*, charged with keeping under review the economic and financial situation of the member States and of the Community, reporting regularly on financial relations with third countries and international institutions, and examining, at least once a year, the situation regarding the movement of capital and the freedom of payments (article 114 of the Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts).

[49] See Jacques Polak, "The IMF and its EMU members", in *EMU and the International Monetary System*, Paul R. Masson, Thomas Krueger and Bart G. Turtelboom, eds. (Washington, D.C., IMF, 1997), pp. 491-511.

expectation of exchange-rate movements can result in large capital flows. ECB can be expected to take the desirability of exchange-rate stability into account as it fulfils its mandate of seeking price stability within Europe. For instance, it would not be fulfilling its obligation to help the Community achieve a "high level of employment" if the exchange rate were to appreciate so sharply as to render large sections of European industry uncompetitive.

Internationally, the euro raises the profile of Europe in global monetary policy. However, as its negotiating partners have found on numerous occasions in the past, the internal decision-making processes of EU can be complicated and lengthy. Nonetheless, these processes have finally arrived at what even a few years ago seemed difficult to achieve: working arrangements for monetary union acceptable to all participants. Similarly, in time changes might be sought in the international monetary system that will make exchange rates between the euro and the other currencies more stable, without a reversion to fixed exchange rates.

The global shock from the Asian currency crisis

The Asian currency crisis of 1997-1998 was unexpected and became far worse than imagined when it began. By the time the international financial panic had largely run its course in early 1998, participants in global financial markets were in shock, as were the people in the "emerging market" economies who, as the Deputy Prime Minister and Minister of Finance of Malaysia described it, saw themselves suddenly go from *paradiso* to *inferno*.[50] The Asian crisis has prompted considerable reflection, criticism and proposals for reform at both the national and the international level. It seems to have been one of those defining sets of events that change the thinking around the globe about a policy matter. The ensuing discussion reviews some of the difficulties and controversies associated with the Asian crisis.[51]

The crisis in Asian "emerging economies": the problem, the medicine, the controversy

The Asian currency crisis erupted on 2 July 1997 when the Government of Thailand could no longer defend the peg of the Thai baht to the United States dollar.[52] The Government suspended 16 non-bank financial institutions in late June, underlining the fragility of the Thai financial sector, into which a great deal of foreign funds had flowed. On 5 August, after the exchange rate of the baht had fallen more than 25 per cent against the dollar, the Government introduced a comprehensive economic reform programme which had been designed in conjunction with IMF, and as part of which it suspended the operations of another 42 financial institutions. Later that month, the programme was financially backed by a standby arrangement with the Fund which, when complemented by other official lenders, entailed a pledge of over $17 billion in support.

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[50] Datuk Seri Anwar Ibrahim, statement to the special high-level meeting of the Economic and Social Council of the United Nations with the Bretton Woods institutions, 18 April 1998 (see E/1998/SR.4).

[51] The present section draws on a large and rapidly growing literature on the East Asian crisis and the unprecedented amount of documentation provided to the public by IMF on its Internet Web page (see www.imf.org). The analysis has also benefited from discussions with IMF, although the views expressed are those of the Secretariat of the United Nations and not necessarily those of the Fund.

[52] The review and assessment of the Asian crisis presented here is perforce concise. For a fuller discussion, see *Economic and Social Survey of Asia and the Pacific, 1998* (United Nations publication, Sales No. E.98.II.F.59), chap. III, sect.. , entitled "The crisis in East and South-East Asia".

Two aspects of the IMF programme stand out. One was the substantial amount of money pledged and the broad grouping of contributors, comprising Japan; Australia; Brunei Darussalam; China; Hong Kong, China; Indonesia; Malaysia; the Republic of Korea; Singapore; the Asian Development Bank; and the World Bank, as well as IMF. The other was the content of the reform programme. In addition to macroeconomic and financial sector reforms, a set of structural initiatives was promised "to increase efficiency, deepen the role of the private sector in the Thai economy, and reinforce its outward orientation, including civil service reform, privatization and initiatives to attract foreign capital".[53] Investors had put large amounts of funds into Thailand over the years believing it to be a dynamic, open and rapidly growing economy. The message that investors took from the new reform programme was that Thai development had fallen into deep trouble.

The Thai adjustment programme

In some respects, Thailand appeared to be facing a typical balance-of-payments crisis in July 1997: the current-account deficit had grown unusually large in 1995 and 1996, mainly owing to a series of adverse international trade and exchange-rate developments; the exchange rate had become overvalued, although the large deficit was easily financed with large capital inflows; the Government resisted advice to adopt the conventional response and devalue the exchange rate; and then, in the first half of 1997, official reserves – which had risen above six months' worth of imports by the end of 1996 – were virtually exhausted in the effort to neutralize the repeated surges of foreign and domestic financial outflows from the country.

Except, Thailand did not look like a typical economy in a conventional balance-of-payments crisis. Inflation was not especially high (about 6 per cent a year since 1995), although the average inflation rate had been about half as high in much of the 1980s. The fiscal balance had been in surplus throughout the 1990s. Thailand was an increasingly diversified and relatively efficient producer of manufactures and services, as well as agricultural commodities. There was some concern about the level of education spending and a question of how smoothly Thailand would move "upmarket" to produce and design increasingly sophisticated goods as other, lower-income countries became more competitive in making standardized manufactures; but there still seemed to be some – if limited – time to address that issue. Domestic saving and investment were high; investment, especially in construction and real estate, was possibly too high. Infrastructure investment had not kept pace and vehicle traffic in Bangkok was notorious. However, there was no end to the numbers of international investors who wanted to bring funds to this politically stable, beautiful and open country, where incomes per capita had been growing more than 5 per cent a year for at least 20 years.

Suddenly, however, there was a large outflow of funds. In part, this reflected recent changes in the composition of capital inflows, as potentially volatile short-term credits had eclipsed the earlier dominance of FDI. The shift had been compounded by a Thai policy to establish an offshore financial centre, the Bangkok International Banking Facility, which eased local access to short-term foreign currency loans. Moreover, in the light of the depressed economic conditions and very low interest rates in Japan, falling interest rates in the other major economies (see table A.9), higher Thai interest rates and a stable exchange rate, Thailand was a magnet for international financial flows. As 1997 progressed,

[53] See IMF, "The IMF's response to the Asian crisis", April 1998, box 2 (available on the IMF Web site at www.imf.org/External/np/exr/facts/asia.htm).

however, the stability of the Thai exchange rate became more and more uncertain and the funds began to flee.

During the period of easy availability of foreign funds, Thai companies and financial enterprises took on greater and greater foreign currency obligations that were largely left unhedged. Most foreign investors and Thai businesses had ignored the possibility of a major baht devaluation (the exchange rate had been about 25 baht per dollar for over a decade and had been close to 20 baht per dollar since the 1960s).

With funds thus pouring in, the foreign currency exposure of the economy grew rapidly. Indeed, one of the reasons it was difficult for the Thai authorities to take the decision to devalue was that they knew the foreign exposure of the financial sector had become excessive and many institutions would quickly be in financial difficulty once devaluation had raised the domestic currency cost of their foreign obligations. With hindsight, the Thai authorities needed to limit the growth of that exposure before it became excessive and they needed to communicate that need to the market before the situation reached the point at which the announcement would itself set off a panic. Thai regulation and policies could also be faulted on other grounds, as the non-bank financial institutions had taken on inappropriate degrees of domestic risk and several were already bankrupt before July 1997 (the real estate bubble burst in 1995 and the stock market crashed in mid-1996).

In short, the financial regulatory regime in Thailand had not kept up with the requirements of the increasing complexity and international integration of its financial markets resulting from financial liberalization. In this regard, Thai policy makers were not unique. There had also been important regulatory lapses in Japan and Latin America in the 1990s, in the United States at the end of the 1980s, and in numerous European countries. However, owing to Thailand's pegged exchange rate and the open access of Thai markets to international flows, including short-term banking and portfolio flows, Thailand was especially vulnerable to the consequences of under-regulation.

The economic difficulties in Thailand in mid-1997 could thus be characterized as a balance-of-payments crisis triggered by a loss of investor confidence in Thai assets, plus a weak and undersupervised financial sector. The financial sector problem required assessing the true state of the financial enterprises, consolidating the insolvent ones into a smaller number of viable ones, arranging liquidity and capital as appropriate to support the viable institutions, and bolstering the regulatory machinery and the regulations of Government. The balance-of-payments problem required some combination of increased exports and reduced imports, along with new capital inflows to finance the deficit while the trade adjustment took effect. The devaluation itself would promote the adjustment, as it raised the relative prices of – and thus incentives to produce – tradable goods. Official international support, as mobilized by IMF, was also needed to help finance the deficit in the short term, while private sector confidence was being restored.

Two other policy instruments, however, were also deployed and both were controversial. One was fiscal tightening, a mechanism whose importance was clear in countries with high levels of inflation brought about by the monetization of excessive fiscal deficits. The usual analysis links the balance-of-payments deficit to excess aggregate demand that originates in the Government's excessive spending and fiscal deficit. The Thai payments deficit was ipso facto evidence of excess demand and it seemed that fiscal tightening would ease that problem. Thus, the Thai adjustment package included steps to reduce government expenditures and raise taxes. While it had its supporters, that part of the Thai rescue package was immediately questioned. The fiscal balance had only just

moved into deficit for the first time this decade, mainly owing to the economic slowdown.[54] Government austerity did not seem to be the answer since government profligacy had not been the problem. The source of the problem was in private-sector decisions regarding expenditure and production.

The other controversial policy decision was to raise interest rates and tighten overall liquidity in the economy. Monetary tightening is indeed a policy that will reduce aggregate demand – in particular, private spending – and thus reduce a balance-of-payments deficit. It was also expected that increases in interest rates could change the minds of the people who had been moving their funds out of baht. Except that credit tightening in this case also created a major problem for Thai businesses, which not only had to make higher baht payments to foreign creditors and suppliers, owing to the devaluation of the baht, but also found it difficult and expensive to get new credit for operations.[55] With 58 financial institutions suspended from operating, with burgeoning financial debt-servicing obligations in terms of local currency, and with a broad loss of confidence in the financial sector, the economy needed more, not tighter, liquidity.

The expenditure and production switching that devaluation was supposed to set in motion required the normal access of enterprises to short-term credit. With the credit crunch, the result instead became production reduction, a major recession, and substantially more local bankruptcies than originally envisioned. In addition, interest rate increases did not bring back foreign funds. Increases in interest rates have achieved this in other countries and at other times, but they were simply overwhelmed by the psychological and economic environment of Thailand at that time.

Moreover, some of the adjustment measures entailed steps that were politically difficult to take. There was thus a lag in implementation, which did not help rebuild confidence. It was not until a new Government came into office some months later that the fate of the programme seemed secure. Indeed, the economy worsened more than had been anticipated in the August programme and it had to be revised in a new agreement with IMF in November. It had to be revised yet again in February 1998 as the economic outlook embodied in the November programme again turned out to have been excessively optimistic. The Government pledged in these revised programmes to accelerate plans to protect the weaker sectors of society and to deepen the social safety net. Meanwhile, the economy continued to spiral down and jobs evaporated.

Finally, in early 1998, the financial situation stabilized. The exchange rate, after falling to less than half its pre-crisis level against the dollar, began to rebound. As of April, however, the net depreciation was still more than 35 per cent of the pre-crisis level. The Thai stock market also began to recover, but equity prices in April were still only half their level in mid-1997 (and that had been 60 per cent under the level at the beginning of 1996). The real economy of incomes and jobs, moreover, had yet to change its downward trajectory (see chap. II).

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[54] The "consolidated" fiscal balance was weaker than the budgetary fiscal balance, owing to quasi-fiscal activities of the central bank, in particular those arising from its support of ailing Thai financial institutions. However, it does not follow that, if this was a problem, the solution was to squeeze the conventional budget rather than limit quasi-fiscal net expenditures (for background on these and related issues in measuring fiscal deficits, see *World Economic and Social Survey, 1997: Trends and Policies in the World Economy* (United Nations publication, Sales No. E.97.II.C.1), chap. V, sect. entitled "Which deficit matters? How small should it be?").

[55] At the same time, given the importance of imported inputs in many categories of output, production was also hampered by the disappearance of trade credits.

Contagion and controversy

While the severity of the Thai crisis was unexpected, it was also surprising that variations of the Thai experience soon followed in other countries. The crisis of confidence that had brought down the baht quickly spread to Indonesia, Malaysia and the Philippines and it entrapped the Republic of Korea by the end of 1997. In each case, investors saw weaknesses where they had previously perceived strengths. They reduced their assets in local currencies – this was quickly reflected in stock market tumbles and credit withdrawals – and forced down exchange rates. In some cases, the main weaknesses were seen to be in the balance of payments (either the size of the current-account deficit or the potential volatility of its financing); in other cases, the primary concern was the domestic financial sector (involving questions of financial strength, political interference and protection of institutions, entanglement rather than arm's length relations with borrowing companies, and a lack of transparency in financial data and operations).[56]

A second source of contagion, at least for countries in South-East Asia, was the belief, once the baht was devalued, that the currencies of regional trading partners and competitors would also have to fall. This form of contagion was a main reason for the pressures on the currencies of Singapore, Taiwan Province of China, and Hong Kong, China.

In most of these latter cases, however, the economic situation did not deteriorate to the degree it had deteriorated in Thailand. Only Indonesia and the Republic of Korea required concerted international support, although the Philippines decided to extend and augment its existing IMF-supported programme; but, as in Thailand, the programmes of both the Republic of Korea and Indonesia were fraught with controversy and were revised at least twice.

Some observers saw in the programme of the Republic of Korea the adoption, under foreign pressure, of trade and investment policies that took the Republic of Korea beyond the concessions it had been willing to offer in international negotiating forums. Moreover, the policies pledged in the Republic of Korea's IMF agreement went beyond financial sector reforms and fiscal contraction (also controversial, as in Thailand) and included fundamental changes in government, business and labour relations. Regardless of whether or not these reforms were in any case wanted by the authorities of the Republic of Korea or the people, observers have questioned their being the subject of IMF agreements.[57]

The controversy on Indonesia has taken place on several fronts. The issue on one front was that, far from stabilizing the situation, the initial programme had contained measures that ignited a run on Indonesia's banks. The Government shifted public sector deposits from commercial banks to the central bank, which squeezed liquidity. In addition, in a system without deposit insurance, the agreed suspension of the operating licences of 16 troubled commercial banks depleted confidence and provoked massive efforts to move

[56] There were instances of contagion outside the region, also associated with loss of investor confidence, for example, in the Czech Republic (which devalued before the baht, but after pressure on the baht had begun), the Russian Federation, Ukraine, South Africa (affecting especially the stock market) and Brazil (see Barry Herman and Krishnan Sharma, "Financial flows, financial crisis, financial policy needs", in *International Finance and Developing Countries in a Year of Crisis*, B. Herman and K. Sharma, eds. (Tokyo, United Nations University Press, 1998), pp. 15-20).

[57] For example, a former Chairman of the Council of Economic Advisors of the United States President and present head of the National Bureau of Economic Research wrote, "The legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions. A nation's need for short-term financial help does not give the IMF the moral right to substitute its technical judgements for the outcomes of the nation's political process" (Martin Feldstein, "Refocusing the IMF", *Foreign Affairs*, vol. 77, No. 2 (March/April 1998), p. 27).

deposits from domestic to foreign banks. Critics have charged, moreover, that the programme did not address the business sector's difficulties in servicing its massive short-term foreign debt. With the continued fall of the rupiah, this became a major crisis in itself by January 1998 and in ensuing months, as the Government entertained unrealistic reform proposals that sapped confidence even more. By the end of April, however, Indonesia was working with IMF to develop a framework for resolving the problem with its foreign bank creditors.

Perhaps the gravest problem in the case of Indonesia was its not being able to reach an agreed reform programme that could be implemented by the Government. IMF negotiations with Indonesia began in October 1997 and, despite various announcements of formal agreements and public signings of letters of intent, they cannot be said to have concluded by the close of work on the present *Survey* at the end of April 1998. Besides the standard components of adjustment programmes, major challenges were made to the economic strategy and policy operations of the Indonesian Government, and these policy differences were very difficult to bridge. Meanwhile, the social and political stakes mounted because of the effects on the country's large, vulnerable population (worsened by the weather disturbances associated with the El Niño phenomenon).

All during this period, IMF and other official actors in the international community were increasingly attacked in the media, by academic critics, by former government officials, and in certain legislatures. Some of the critics attacked the unprecedented $112 billion in official loans that IMF had mobilized from various sources to support the three countries, saying it was a bailout for foreign private lenders; other critics took issue with the policy programmes.

The latter critique focused on the sharply contractionary macroeconomic targets set for the Asian economies by IMF and the austerity that accompanied them. It was argued that they were irrelevant to the real problem, which was financial market failure owing to inadequate government regulation. The Chief Economist of the World Bank argued that the problem was not that Asian Governments had misdirected credit, but that they had failed to stop private markets from misdirecting credit.[58]

While the Fund agrees completely with the need for strengthened financial market supervision, it has maintained its strict macroeconomic prescriptions, albeit with an easing up, as the economies plummeted. The difficulty seems to be that once countries opt for fully open currency markets, they need to adopt macroeconomic policies that financial investors deem to be required and "austerity" appeared to be the first principle of adjustment in their view. According to the Managing Director of IMF, in a speech on 6 February 1998, "the first order of business was, and still is, to restore confidence in the currency", which is why interest rates had to be raised.[59] He argued that observers misperceived the IMF programmes in Asia: "the centrepiece of each programme is not a set of austerity measures to restore macroeconomic balance, but a set of far-reaching structural reforms ..."

One aspect of these structural reform packages became particularly contentious, namely, the taking of steps towards full liberalization of financial and currency markets. The IMF Interim Committee, the Fund's ministerial oversight body, had decided in April

[58] Joseph Stiglitz, "More instruments and broader goals: moving towards the post-Washington consensus", The 1998 World Institute for Development Economics Research of the United Nations University (WIDER) Annual Lecture, Helsinki, 7 January 1998, pp. 2-3 of typescript.

[59] Michael Camdessus, "The IMF and its Programmes in Asia", remarks at the Council of Foreign Relations, New York, 6 February 1998 (Stiglitz, in the above-cited lecture, argued that such interest rate increases could be "counterproductive" and worsen the crisis).

1997 to seek to amend the Articles of Agreement of the Fund so as to bring capital movements formally under its jurisdiction and make the liberalization of international capital movements "a central purpose of the Fund". The post-crisis statement of the goal was first detailed in a lecture during the September 1997 Annual Meetings of IMF and the World Bank in Hong Kong, China, delivered by the First Deputy Managing Director of IMF. He said that capital-account liberalization had to be phased appropriately, "which means retaining some capital controls in transition".[60] He favoured "market-based" controls, such as were maintained by Chile over quantitative limitations on flows and he left unclear how long the transition would be.

By the time of the 6 February speech of the IMF Managing Director (noted above), the statement on timing of capital-account liberalization had been further refined to a "properly sequenced and cautious liberalization". In his remarks at the 18 April special meeting of the Economic and Social Council, the Managing Director implicitly refined the timing even more, as he noted that IMF had sought to foster current-account liberalization for over 50 years, that there were still a number of countries with restrictions on current flows and that there was thus little reason to anticipate that capital-account liberalization could be accomplished quickly.[61] In short, it seems that if there once was an international consensus on a quick move to full capital-account liberalization, it has now disappeared.

Financial market views of the crisis: missed perceptions and market failures

Parallel to the questioning in policy-making circles, a deep concern arose in the private financial community. Those at the operational centre of the global financial system have found the Asian crisis an extremely troubling experience. Although their written commentary may not reflect it for reasons that are not difficult to imagine, their confidence was rudely shaken.[62]

Up to the very eve of the crisis, most market participants thought that the investment prospects in South-East Asia and the Republic of Korea were good. Short-term equity, bond and foreign exchange traders, long-term investment strategists, merchant bankers, economists, credit analysts, and credit rating agencies all generally thought that the investment outlook for the region was sound.

Market participants were aware that many of the financial systems in the region were not well developed or well regulated and that "cronyism" and corruption were a normal part of business practices in several countries. They knew that in many instances the local current-account deficits were sizeable, that external debt burdens were large and growing, and that the macroeconomic conditions and export performance in the region were not as positive as in the past. They were aware that the speculative activities in, and short-term capital inflows into, the region were becoming more pronounced. These market participants saw that signs of excess capacity and financial stress were emerging, particularly in Thailand and the Republic of Korea; and just ahead of the crisis, they understood that the fixed exchange rates of some of the countries were probably overvalued.

[60] Stanley Fischer, "Capital account liberalization and the role of IMF", presentation to IMF Seminar on Asia and IMF, Hong Kong, China, 19 September 1997.

[61] See E/1998/SR.4.

[62] The discussion in the present section is based on a study of New York market sentiment, derived from written commentary and analysis produced by large multinational banks, interviews with some of the major decision makers at these and other private sector financial institutions, newspaper reports and other sources, private and official. The assistance of market participants in this exercise, most of whom cooperated on condition of anonymity, is gratefully acknowledged.

Nevertheless, market participants chose to ignore all of these considerations and to focus instead on the region's high growth and comparatively low inflation rates, the lack of significant budget deficits, the openness of the region's markets, the laissez-faire attitude of its businessmen, and the high rates of return that their past investments in the region had yielded. It was under these favourable perceptions that foreign capital continued to flow into several of the crisis countries well into the second half of 1997.

The financial crisis does not seem to have been induced by "moral hazard". If foreign traders and investors underestimated the actual risks, it was because they were genuinely sanguine about the outlook for the region, not because they thought that their investments would be guaranteed.[63] This is why most of them left themselves exposed, why they subsequently panicked, and why the traders and securities investors incurred substantial losses.

The attitude of bankers, on the other hand, was more nuanced. Bankers deal more directly and over longer periods with borrowers than do purchasers of securities in markets, and they were keenly aware of informal relationships among the business, financial and government sectors. There was also a history from the 1980s debt crisis to lead bankers to believe that in time of difficulty Governments would step in. In the end they were right, as it was Governments that negotiated the formal and informal arrangements with the international banks to roll over and extend the loan maturities of the debts of their private sectors.

As of early 1998, the crisis began to abate in the sense that most exchange rates and stock markets in the Asian region stabilized. The crisis, however, had left considerable damage in the international markets. It traumatized many market participants. Foreign investors in East Asia panicked when they suddenly discovered that significant losses on their investments there were unavoidable.

The crisis damaged something more than just investors' confidence in a certain geographical part of the globe. Emerging markets were known to involve higher risk, but diversifying investments across many countries was supposed to dilute the risk. The shock that most market participants felt when they watched the financial contagion spread rapidly out from Thailand to the rest of East Asia and then to the global capital markets was palpable. The financial markets were crashing and beyond anyone's control, gripped by a set of forces that could not be resisted until they had run their course. Market participants saw that the international financial markets were not operating as a means for allocating capital efficiently across countries, but instead had become a mechanism for spreading financial panic from one nation to the next. The recognition that this was a private and not a public sector problem forced many market participants to question some of their most deeply held beliefs about how the globalized market economy worked.

Before the crisis, market analysts saw the emerging economies of East Asia as "doing everything right" and the risk of investing in those markets seemed manageable. In an age of "go-go" markets, these economies were praised both for their remarkable growth rates and, even more significantly, for the very high rates of return that they offered to local and foreign investors. When the East Asian countries collapsed into financial chaos in 1997, market participants were therefore compelled not just to reappraise the realities, but to question as well the validity of the current idealized model of what capitalism should be in the Third World. Since the emerging market economies that were "doing everything right" could go wrong, investors were left wondering, What was the right thing to do?

[63] The Governments of Thailand and the Republic of Korea did offer certain assurances about bailouts when the crisis was already at hand, but these came very late and lacked credibility.

Market participants could make either of two responses to this disillusionment. One was to come to terms with the troubling question why, in the very emerging markets that were doing everything right, unregulated "free market" capitalism could bring about such a disastrous result. This led to questions about how the markets function and the need for countries to adopt market regulating policies. Alternatively, since market participants' beliefs about the viability of free markets were deeply held, they could doubt that the markets had ever been "free". According to this view, markets were never allowed to flourish in these countries because of "crony capitalism", moral hazard and the like. Here the problem was seen to lie not in the markets but in the countries, and people who argued this line saw the virtue in pushing towards more complete economic liberalization.

Yet even those who believed the problem lay in the countries had to ask why they had been blind to it. At least four problems connected with their strategies in the region must have become apparent. First, they had not seen that the Asian economies were in trouble and so continued to increase their financial exposure to the region until the last moment. Second, they had completely underestimated the aggregate market exposure that, collectively, they now had in "emerging Asia". Third, as the risk premiums on the credits of the region had continued to narrow up until the very eve of the financial explosion, the supposedly rational and efficient international financial markets themselves did not give them any warning signs about the dangers inherent in these exposures. Fourth, they discovered they could reduce their positions in the region only by realizing sizeable losses, because the requisite liquidity for an easy exit was lacking.

Why had market participants not seen that the crisis was coming until it was too late? Why had they been so inattentive, not just to the now obvious foreign exchange risks, but also to the much more troublesome, if somewhat less obvious, aggregate market risks that were currently pulling them down? Why, had the markets not priced in the true risks? Why, precisely during a period of systemic failure, does market liquidity vanish just when it is needed the most?

Some answers to these questions defend market rationality by pointing to certain exceptions to its rule. Informational asymmetries may have prevented market participants from keeping up with developments in East Asia. Fallacy-of-composition mistakes, when made by a group of even the most prudent of investors, can produce collective aggregate market exposures of unreasonable sizes. Market failure can account for the decline in interest risk premiums ahead of the contagion. Liquidity is always a problem in one-way markets. Furthermore, moral hazard, as well as the illusion of certainty associated with a fixed exchange-rate regime, may have played a crucial role. In short, market participants could come to terms with these questions in such a way as to keep their faith in the markets intact.

However, defending the market's rationality by pointing to situations when this rationality breaks down must have its limits. Indeed, given the extent of the mistakes that the foreign investors had made, the information asymmetry, fallacies of composition, market failure, moral hazard, adverse selection and other similar problems would have had to be so very widespread as to make them not the exception to the rule, but the rule itself. The cumulative thrust of the investors' questions, therefore, has pushed a number of market participants in the direction of a very different and much more rudimentary line of inquiry.

Financial policy advice from market professionals

One way of thinking about the quandary that many market participants were in is to assume, as a simple fiction, that market participants typically move back and forth between two different roles when they engage in policy discussions: that of the actively engaged

businessman and that of the neutral market professional who is able to take a broader view of his market. As businessmen, market participants will resist any reforms that might restrict their own room for manoeuvre, but will push for reforms that advance their interests, especially vis-à-vis their competitors. As neutral professionals, on the other hand, market participants will act responsibly to improve general market conditions and practices, often working closely with their competitors and the relevant authorities to make certain that everyone, including themselves, acts responsibly.

Acting as self-interested businessmen, international market participants have very little to say about their roles in the East Asian financial crisis, as it is not in their interest to admit that they were accountable in any way. As enlightened market professionals, on the other hand, they acknowledge that their collective speculative excesses played a key role in both the origins and the spread of the contagion. They therefore recognize the need to find the regulatory systems and early warning mechanisms that either will prevent them from taking on such risky aggregate market exposures in the future or will push them to cut their exposures well before another full-fledged crisis begins to take place.

Since the market and other informational failures that lay behind their taking on such excessive aggregate market exposures in East Asia were massive, the required regulatory changes would have to be far-reaching and the early warning systems elaborate. First, the widely accepted – but decade-old – capital standards of the Basle Committee on Banking Supervision would have to be reviewed to see if stricter limits should be placed on the credit and market exposures of banks. Similar concerns would apply to non-bank financial institutions. Second, private sector financial institutions would need to strengthen their own internal risk measurement and control systems. Systems would have to be put in place that allowed them to measure not just their aggregate credit exposures, but – and on a day-to-day basis – their aggregate price and interest rate risks across financial markets as well. Should the measured risks become excessive, enterprise risk managers would have to have the authority to cut the exposures. Third, the monetary authorities of the major industrialized nations would have to establish procedures to monitor the total aggregate market risks that the financial institutions under their jurisdiction collectively took on and hence to warn their institutions when these positions became excessive. Fourth, international efforts would be required, under the auspices of the Bank for International Settlements (BIS) in Basel, IMF or perhaps a new institution, to measure and regulate the aggregate market exposures that all of the major private financial institutions took on within particular areas of the globe. Fifth, central bankers and international monetary authorities would have to work closely with private sector financial institutions to establish an early warning system that could alert market participants to pending economic and financial difficulties in individual countries and regions.

As actively engaged businessmen, however, market participants would object to these proposals vehemently, and to such a degree that few of them would find the proposals acceptable. The regulatory burden of the Basle Committee capital rules, they would argue, was already great. In keeping with new BIS rules about market risk, they were already developing their own sophisticated internal risk measurement and management systems. They would probably resist the extra information costs and regulatory burdens of implementing the third and fourth suggestions. The fifth proposal about establishing an international early warning system might be just too elaborate. However desirable these

and similar mechanisms might be from the public policy point of view, market practitioners would see them as too burdensome, too costly, too elaborate and simply not realistic.[64]

Turning to the question of limiting international contagion once a crisis begins in one country, the gap between what market participants will recommend as market professionals and what they will accept as businessmen is even greater. Since it is clear that international financial markets can at times become dysfunctional, market participants, as disinterested market professionals, would be willing to consider the use of a variety of solutions in order to limit the damage of financial volatility in one market that is caused by problems elsewhere. These would include taxes on foreign exchange transactions and capital controls, temporary or otherwise. Since the jurisdiction of any national authority is limited to its own borders, they might also see a need to create regional or international supervisory structures to enforce the taxes and capital controls and to otherwise regulate the international capital markets. As actively engaged businessmen, on the other hand, they know that they would immediately find ways to avoid and evade any of these controls and regulations, pointing out as well that enforcement would be very difficult, if not impossible, across so many borders and jurisdictions. Besides, they might counter, flexible exchange rates would provide a better and simpler solution.

Finally, the attitude that market participants have today towards IMF is complex and contradictory. It is not easily sorted out by the expository device of splitting their personalities into those of businessmen and professionals. Most market participants supported the stabilization efforts that the Fund undertook as the crisis in East Asia was unfolding. They were willing to defend the Fund against criticisms that its conditionality was too severe, on the grounds that austerity was needed to restore market confidence in the local exchange rate. Moreover, market participants were quick to show displeasure with any Government in the region that seemed to deviate even in the slightest from the programme that it had signed with the Fund: if they thought that the Government was not living up to the programme, market participants saw no reason to hold the country's assets and so sold them aggressively. Furthermore, today market participants generally believe that IMF needs to be fully funded, noting that it is the only institution in existence with a mandate to deal with emerging-market financial crises that may appear in the future.

This being said, most market participants appear to believe that the Fund's stabilization efforts in East Asia failed to limit the foreign exchange contagion, and may have made the domestic financial problems worse, particularly in Indonesia. Focusing on the need to restore foreign investor confidence in the local exchange rates, the Fund's support for fiscal austerity, tight monetary policy, rapid bank closures, and the enforcement of capital adequacy standards was seen to have aggravated existing domestic financial difficulties rather than to have ameliorated them. In other words, they appear to believe that the Fund caused a further destabilization in already weak domestic financial systems, which, in turn, undermined the exchange-rate stability that its programmes might otherwise have achieved.

[64] Indeed, BIS was holding a conference on how to measure aggregate market risk in the spring of 1997, just when the East Asian crisis was beginning to unfold; it seems to have concluded that these and similar schemes were not feasible (see Bank for International Settlements, *The Measurement of Aggregate Market Risk* (Basel, 1997)).

Conclusion: a time for humility and debate

Market participants, in any event, are only one set of players in international finance and it is for Governments, representing all of society, to set policy. In this regard, the main conclusion arising from the developments of the past year seems to be that the international community needs a full appreciation of the limits of present policy. It appears that the case for quick and complete liberalization of financial markets and capital flows has lost considerable support. So, too, has the case for applying austerity when it threatens to collapse a large part of a weak financial system. There is also renewed interest in an international "lender of last resort" to supply unconditional liquidity to qualifying countries in the same way that central banks do in national crisis situations.[65] This is not to say that a consensus has formed around this or any other of the more radical proposals, but rather to suggest that owing to the Asian crisis such proposals are getting much more of a hearing.

The Asian crisis, in other words, has been a sobering experience for international policy makers in capitals as well as in international organizations. The degree of political and social disruption that has been seen was obviously not what IMF negotiators had intended. Perhaps the economic, social and political situations would have deteriorated even more if not for the reform programmes, but this is not assured. As the lead agency in promoting macroeconomic and financial reform, as well as in arranging the large financial packages that accompanied it, IMF has borne the brunt of the concern and criticism. Most of the critics call for reform of IMF and for more flexibility in its policy advice. In the first quarter of 1998, these and related concerns were being raised with increasing political force around the world.

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[65] See, for example, Ariel Buira, "Key financial issues in capital flows to emerging markets", and Arjun Sengupta, "Managing financial flows for development" in *International Finance and Developing Countries in a Year of Crisis*, B. Herman and K. Sharma, eds. (Tokyo, United Nations University Press, 1998), pp. 59-72, and 81-93, respectively; and James Tobin, "Financial globalization: can national currencies survive?", keynote address at the Annual World Bank Conference on Development Economics, Washington, D.C., 20 April 1998.